TEXAS REVIEW *of* LAW & POLITICS

VOL. 14, NO. 2 | SPRING 2010 | PAGES 209–422

TAX-EXEMPT CREDIT COUNSELING ORGANIZATIONS AND THE FUTURE OF DEBT-SETTLEMENT SERVICES

RONALD D. KERRIDGE* & ROBERT E. DAVIS**

* Ronald D. Kerridge is a tax lawyer and a partner in the firm K&L Gates LLP.

** Robert E. Davis is a tax litigator and white-collar defense lawyer who has served as Deputy Assistant Attorney General in the United States Department of Justice, and a partner in the firm K&L Gates LLP. A portion of this article was previously submitted to the FTC in a different format as a comment on the Notice of Proposed Rulemaking on October 26, 2009, and Mr. Davis participated in the FTC's public forum concerning the Notice of Proposed Rulemaking held on November 4, 2009.

I. INTRODUCTION

On July 30, 2009, the Federal Trade Commission (FTC) proposed amendments to its Telemarketing Sales Rule that would significantly impact for-profit providers of various debt-relief services. Set out in a Notice of Proposed Rulemaking, these changes would: (1) mandate certain disclosures about the services being provided, including the cost of those services and the time frame in which debt relief would occur; (2) prohibit misrepresentations concerning the service provider's success rate in obtaining debt relief and its status as a for-profit or non-profit organization; (3) make the Telemarketing Sales Rule applicable to "in-bound" calls, i.e., calls made by consumers in response to advertising by debt-relief service providers; and (4) prohibit "advance fees," meaning that debt-relief providers could collect fees only after rendering the services in question.[1] The Notice of Proposed Rulemaking would define "debt relief service" to include any renegotiation, settlement or alteration of the terms of consumer debt, including reductions in the balance owed, interest rate, or fees.[2] These changes would apply only to for-profit debt-relief service providers, because the jurisdiction of the FTC does not extend to non-profit entities.[3]

For a number of years, for-profit debt-settlement service providers and non-profit credit counseling organizations—many of which are also exempt from federal income tax—have competed to provide services to individuals who are burdened by excessive consumer debt. Such individuals typically have three primary options: bankruptcy, debt management plans, and debt-settlement services.

The alternative of bankruptcy—which has long had many downsides for the debtor such as a long-term adverse impact on the debtor's credit rating—became significantly more problematic as a result of the enactment of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[4] That

1. FTC Telemarketing Sales Rule, 16 C.F.R § 310 (2009).
2. *Id.*
3. *Id.*
4. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) (requiring also that debtors obtain credit counseling prior to

Act made it more difficult for many consumers to qualify for relief under Chapter 7 of the Bankruptcy Code, leaving Chapter 13 as the bankruptcy alternative. The Act made changes to Chapter 13 which required many consumers to repay a higher percentage of their unsecured debt than was previously the case, with liability under a plan requiring payments over a future period of three to five years.

Debt management plans should be designed to result in repayment of the full principal amount owed by the consumer. These plans, which are generally provided and administered by non-profit, tax-exempt credit counseling organizations, typically involve extensions of time to pay and, in some instances, concessions by the creditors on interest rates and fees that would otherwise apply.[5] The credit counseling organizations receive "fair share" payments from the creditors that are a percentage of the amount of debt repaid by the consumer debtors.[6] Debt-settlement services, by contrast, involve negotiation by the service provider to reduce the principal amount of the debt in exchange for a lump-sum payment.[7] These services are typically provided and administered by for-profit entities, which are paid fees by the consumer debtors.[8] The relative efficacy of debt management plans and debt-settlement services, and the number of "bad apples" within the two groups of service providers, is sharply controverted by the two camps.[9]

Not surprisingly, non-profit credit counseling organizations generally favor the prospect that the Telemarketing Sales Rule will be expanded as described in the Notice of Proposed Rulemaking, while for-profit debt-settlement providers generally oppose certain aspects of the proposed amendments. In its comments to the Notice of Proposed Rulemaking submitted to the FTC on October 26, 2009, the United States Organizations

---

filing for bankruptcy protection, a mandate that produced considerable additional demand for credit counseling services).

5. *See*, UNIFORM DEBT-MANAGEMENT SERVICES ACT Prefatory Note at 1 (Proposed by National Conference of Commissioners of Uniform State Law 2008) (explaining debt management plans generally).

6. *Id.*

7. *Id.*

8. *Id.*

9. *See, e.g.*, Public Forum on Proposed Debt Relief Amendments, http://www.ftc.gov/bcp/rulemaking/tsr/tsr-debtrelief/transcript.pdf (discussing the Notice of Proposed Rulemaking held on November 4, 2009).

for Bankruptcy Alternatives (USOBA), a trade organization representing debt-settlement service providers, noted that it was

> pleased to be able to support the vast majority of the proposed amendments to the TSR. Our support of the amendments to the TSR stops, however, with the proposal of a radical, "advance fee ban." This ban is supported and promoted, not coincidentally, by not-for-profit credit counselers, which are a category of debt resolution providers not covered by the NPRM. Thus, credit counselers compete with the very for-profit debt resolution providers that are targeted by the advance fee ban. USOBA believes that the proposed ban is a form of industry protectionism, plain and simple, designed to favor credit counselors in the marketplace by crippling their competition.[10]

The USOBA Comment argued that:

> the advance fee [ban] would injure consumers by driving reputable debt-settlement companies from the market at a time when U.S. consumers need them most. A survey of USOBA members taken after the Commission released the NPRM found that:
>
> - 84% of USOBA members would "almost certainly" or "likely" be forced to shut down if an 'advance fee ban' as described by the Commission were adopted.
>
> - 95% of USOBA members would "certainly" or "likely" be forced to lay off employees if the advance fee ban were adopted [note that 72% of these USOBA members were 'small businesses' (firms of 25 people or less)].
>
> - 60% of those forced into reductions in their workforce would lay off 25 or more employees (a full 25% would lay off 50 or more workers).
>
> - Regarding effects on consumers, 85% of USOBA members would be forced to stop offering debt relief services to new consumers if an advance fee ban were adopted.

10. Jonathan S. Massey & Leonard A. Gail, Comments of United States Business Organizations for Bankruptcy Alternatives (Oct. 26, 2009) (unpublished comment "In the Matter of Telemarketing Sales Rule – Debt Relief Amendments, R411001"), *available at* http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00215.htm, at 19.

- Existing consumers of 85% of the providers responding would lose their current debt relief services.

- 82% would be forced to reduce or limit services to consumers.[11]

If the warnings sounded by USOBA's survey are correct, and an advance fee ban would drive most for-profit debt-settlement service providers out of business, it is appropriate to consider whether tax-exempt credit counseling organizations—which are not subject to the Telemarketing Sales Rule—could then meet the extensive public demand for debt-settlement services. These tax-exempt organizations would presumably be reluctant to expand their activities into debt-settlement services if doing so would jeopardize their tax-exempt status. This analysis leads to the question that is the focus of this Article: would a credit counseling organization that is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the Code), still qualify for tax exemption if it expanded its activities to include the provision of substantial debt-settlement services?

Placing this question in context requires a summary of the history of tax exemption for credit counseling organizations, particularly the increasingly stringent requirements that the Internal Revenue Service (IRS) and Congress have placed on these organizations in response to the changes in the marketplace for debt-resolution services.

II. THE BACKGROUND OF TAX EXEMPTION AND CREDIT COUNSELING ORGANIZATIONS

Section 501(c)(3) of the Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational, and certain other enumerated purposes, provided that no part of their net earnings inure to the benefit of any private shareholder or individual.[12]

Treasury Regulation § 1.501(c)(3)-1(a)(1) provides that "in order to be exempt as an organization described in

11. *Id.* at 20 (emphasis removed).
12. I.R.C. § 501(c)(3) (2006).

section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt."[13]

Treasury Regulation § 1.501(c)(3)-1(c)(1) states that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in Section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[14]

Certain credit counseling organizations have been recognized as exempt under Section 501(c)(3) for many years.[15] The exempt purpose upon which credit counseling organizations have been granted exemption under Section 501(c)(3) is their educational objective. In the leading ruling by the IRS, the organization in question "was formed to reduce the incidence of personal bankruptcy by informing the public on personal money management by assisting low-income individuals and families who have financial problems."[16] The ruling stated the following:

> The organization provides information to the public on budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications. It aids low-income individuals and families who have financial problems by providing them with individual counseling and, if necessary, by establishing budget plans. Under a budget plan, the debtor voluntarily makes fixed payments to the organization. The funds are kept in a trust account and disbursed on a partial payment basis to the creditors, whose approval of the establishment of the plan is obtained by the organization. These services are provided without charge to the debtor.

13. Treas. Reg. § 1.501(c)(3)–1(a)(1) (2008).

14. Treas. Reg. § 1.501(c)(3)–1(c)(1) (2008).

15. The IRS has recognized the exemption of certain credit counseling organizations pursuant to 501(c)(4). Rev. Rul. 65-299, 1965-2 C.B. 165. Relatively few credit counseling organizations are exempt pursuant to section 501(c)(4), perhaps because certain non-tax legal distinctions turn on whether an organization is exempt specifically under section 501(c)(3) *See, e.g.*, Credit Repair Organizations Act, 15 U.S.C. §1679(a)(3)(B)(i); Zimmerman v. Cambridge Credit Counseling Corp., 409 F.3d 473 (2005). Consequently, this Article will address exemption under section 501(c)(3). The principles discussed herein are generally applicable to section 501(c)(4) organizations as well.

16. Rev. Rul. 69-441, 1969-2 C.B.115.

After granting exemption under Section 501(c)(3) to a group of credit counseling agencies, the IRS determined that this exemption had been issued inadvertently and sought to reclassify those organizations as exempt under Section 501(c)(4).[17] These credit counseling agencies sought and received a declaratory judgment from the United States District Court for the District of Columbia determining that they qualified for exemption under Section 501(c)(3).[18] They functioned in a manner similar to the organization described in Rev. Rul. 69-441.[19] The court found that the agencies had two basic types of programs, which together constituted their principal activities: providing "information to the general public, through the use of speakers, films, and publications, on the subject of budgeting, buying practices, and the sound use of consumer credit and . . . counseling on budgeting and the appropriate use of consumer credit to debt-distressed individuals and families."[20] The court also found:

> As an adjunct to the counseling function described [above], an agency may provide advice as to debt proration and payment, whereby a program of a monthly distribution of money to creditors is developed and implemented. In some of these instances, an agency may be required to intercede with creditors to cause them to agree to accept such monthly payment schedule.[21]

The organizations at issue generally charged a nominal fee in connection with such debt management programs, which fee was waived in instances where its payment would work a financial hardship. Approximately 12% of the professional counselors' time was spent in connection with debt management programs.

The court concluded that the community education and counseling assistance programs were the agencies' primary activities. Their debt management and creditor intercession activities were "an integral part of the agencies' counseling function, and thus are charitable and educational undertakings.

17. Consumer Credit Counseling Serv. of Ala., Inc. v. U.S., 78-2 U.S.T.C. 9660 (D.D.C. 1978); *See also* Credit Counseling Ctrs. of Okla., Inc. v. United States, 79-2 U.S.T.C. 9468 (D.D.C. 1979) (drawing substantially identical analysis and conclusions).

18. *See id.*

19. *See id.*

20. *Consumer Credit Counseling Serv. of Ala.*, 78-2 U.S.T.C. at 9660.

21. *Id.*

Even if this were not the case, the agencies' proper designation as IRC § 501(c)(3) would not be disturbed, as these activities are incidental to the agencies' principal functions."[22]

III. INCREASED SCRUTINY OF CREDIT COUNSELING ORGANIZATIONS BY THE INTERNAL REVENUE SERVICE

In the years since this case, the number of organizations providing counseling and other services to debtors has grown substantially.[23] Many of these organizations sought, and were granted, recognition by the IRS as tax-exempt entities.[24] Beginning in 2002, the IRS intensified its scrutiny of claims for exempt status by such organizations.[25] In a written testimony dated November 20, 2003, for the House Ways and Means Committee's Subcommittee on Oversight, Commissioner of Internal Revenue Mark Everson stated:

> Our information systems reflect over 850 credit counseling organizations that have been recognized as tax exempt under section 501(c)(3). In recent years, the Service has seen an increase in applications for tax-exempt status from organizations intending to provide credit counseling services. Among the more recent applicants, we are finding credit counseling organizations that vary from the model approved in the earlier rulings and court cases. We are seeing organizations whose principal activity is selling and administering debt management plans. Often the board of directors is not representative of the community and may be related by family or business ties to the for-profit entities that service and market the debt management plans. The organizations are supported by fees from customers and from credit card companies, and the fees are much higher than those in the rulings or court cases. Finally, it does not appear that significant counseling or education is being provided. . . .
>
> In 2002, as we saw an increasing number of allegations of credit counseling abuses, we contacted the Federal Trade Commission for assistance in understanding the developments

22. *Id.*

23. David A. Lander, *Essay: A Snapshot of Two Systems That Are Trying to Help People in Financial Trouble*, 7 AM. BANKR. INST. L. REV. 161, 162 (1999).

24. Leslie E. Linfield, *Credit Counseling Update: The "Perfect Storm" Brewing*, 24-APR AM. BANKR. INST. J. 30, 46 (2005).

25. Allen Mattison, *Can the New Bankruptcy Law Benefit Debtors Too? Interpreting the 2005 Bankruptcy Act to Clean Up the Credit-Counseling Industry and Save Debtors from Poverty*, 13 GEO. J. ON POVERTY L. & POL'Y 513, 530 (2006).

> in the industry. Based on the available information, it appears that customers, served solely by the Internet, are provided debt management—not credit counseling. The individual budget assistance and public education programs that formed the original basis for exemption under section 501(c)(3) have changed. In many cases, these services appear to have been replaced by promises to restore favorable credit ratings or to provide commercial debt consolidation services.[26]

Over the next two and a half years, the IRS acted decisively to curb the abuses that Everson described.[27] On May 15, 2006, the IRS issued a news release reporting this progress:

> Over the past two years, the IRS has been auditing 63 credit counseling agencies, representing more than half of the revenue in the industry. To date, the audits of 41 organizations, representing more than 40 percent of the revenue in the industry, have been completed. All of the completed audits have resulted in revocation, proposed revocation or other termination of tax-exempt status.[28]

Everson bluntly concluded:

> Over a period of years, tax-exempt credit counseling became a big business dominated by bad actors. Our examinations substantiated that these organizations have not been operating for the public good and don't deserve tax-exempt status. They have poisoned an entire sector of the charitable community.[29]

In addition to the revocations of exemption for many existing organizations, the IRS became much less likely to recognize exemption in connection with applications by newly formed entities seeking exempt status, granting exemption to only three of the 110 applicants between 2003 and 2006.[30] In many instances, the basis for denial of exempt status was an organization's excessive emphasis on debt management plans. Because the rationale for exemption of credit counseling agencies is a primary educational purpose, instances in which

26. *Nonprofit Credit Counseling Organizations: Hearing Before the S. Comm. On Oversight Comm. On H. Ways & Means*, 108th Cong. (2003) (statement of Mark Everson, Commissioner, Internal Revenue Service).

27. *See* Linfield, *supra* note 24 (discussing the process implemented to curb abuses).

28. Press Release, IRS Takes New Steps on Credit Counseling Groups Following Widespread Abuse (May 15, 2006) (on file with the IRS at IR-2006-80).

29. *Id.*

30. IRS, Credit Counseling Compliance Project, Summary & Results (2006) *available at* http://www.irs.gov/pub/irs-tege/cc_report.pdf.

educational activities were overshadowed by debt management plans understandably resulted in denial of exemption.

The IRS even included credit counseling agencies in its widely publicized, annual "Dirty Dozen" list of tax scams, warning that

> Taxpayers should be careful with credit counseling organizations that claim they can fix credit ratings, push debt payment plans or impose high set-up fees or monthly service charges that may add to existing debt. The IRS Tax-exempt and Government Entities Division is in the process of revoking the tax-exempt status of numerous credit counseling organizations that operated under the guise of educating financially distressed consumers with debt problems while charging debtors large fees and providing little or no counseling.[31]

As Everson mentioned in his 2003 testimony, "fair share" payments from credit card companies are a significant source of financial support for many tax-exempt credit counseling organizations. In a 2004 Chief Counsel Memorandum, the IRS considered the potentially problematic character of the relationships between credit counseling organizations and the credit card companies:

> Although the published rulings have indirectly considered the receipt of fair share payments from creditors as generally consistent with exemption under section 501 (c) (3), the way in which credit counseling organizations and their trade associations have recently been tailoring their operations and standards to attend directly to concerns of credit card companies may also provide evidence to support a substantial nonexempt purpose and/or private benefit argument for revocation of exemption. To develop such arguments, it would be necessary to develop specific facts showing that the public interest and the interests of the low-income recipients of counseling services are being sacrificed in favor of the credit card companies. Whether to develop the facts with respect to benefits to the credit card companies is an examination strategy decision. [32]

One source of concern among tax-exempt credit counseling organizations regarding the relationships between credit

31. Press Release, IRS Announces "Dirty Dozen" Tax Scams for 2006 (Feb. 7, 2006) (on file with the IRS at IR-2006-25).

32. I.R.S. Off. Chief Couns. Mem. 04-31-023 (July 13, 2004).

counseling organizations and credit card companies was the 2003 decision of the Maine Supreme Judicial Court denying charitable tax exemption for property owned by Credit Counseling Centers, Inc.[33] The Maine court's analysis focused on that relationship:

> In the present case, the Superior Court erred in its legal conclusion that CCCS is entitled to a charitable tax exemption. In 1995, CCCS collected $8,801,264 for the creditors of the clients with whom it works; in 1996, it collected $9,877,179; in 1997, it collected $11,933,638; in 1998, it collected $13,146,614; and in 1999, it collected $16,715,565. These creditors normally pay between 8.5% and 9% of the amount collected as a "fair share" contribution to CCCS. The magnitude of the amounts collected for creditors clearly demonstrates that CCCS's business is not "conducted *exclusively* for benevolent and charitable purposes," or that the revenue generated is not "purely incidental to a dominant purpose that is benevolent and charitable."[34]

Even more ominously, the IRS began to cite this Maine opinion in private letter rulings denying tax-exempt status to credit counseling organizations. For example, in a 2004 ruling, the IRS articulated the following as of one of the grounds for denying exemption:

> You provide substantial private benefit to credit card companies in a manner similar to the organization in Credit Counseling Centers v. S. Portland. Fair share is commonly defined as "that amount the organization receives from the creditors for each payment remitted to them." In the absence of any charitable or meaningful educational activities you are operating as a collection agency for these companies. The "fair share" paid by the credit card companies would undoubtedly result in significant savings over the possible costs of not recovering any of the unpaid debt owed them. Thus, these companies clearly realize substantial financial benefits through their business relationship with you. We note that your contract with clients' [sic] provides that if they drop out of the DMP, they are still obligated to pay their debts to the

33. Credit Counseling Ctrs, Inc. v. City of South Portland, 814 A.2d 458 (Maine 2003).

34. *Id.* at 463 (internal citations omitted).

> credit card companies. This illustrates the close business relationship you have with these companies.[35]

IV. SECTION 501(Q)

In the Pension Protection Act of 2006, Congress enacted Section 501(q) of the Code[36] which imposes additional requirements on credit counseling organizations claiming exempt status. The legislative history of Section 501(q) recounts the IRS's heightened scrutiny of credit counseling organizations and explains:

> The provision does not diminish the requirements set forth recently by the IRS in Chief Counsel Advice 200431023 or Chief Counsel Advice 200620001 but builds on and is consistent with such requirements, and the analysis therein. The provision is not intended to raise any question about IRS actions taken, and the IRS is expected to continue its vigorous examination of the credit counseling industry, applying the additional standards provided by the provision.[37]

The legislative history provides a useful summary of the significant additional requirements imposed by Section 501(q):

1. The organization provides credit counseling services tailored to the specific needs and circumstances of the consumer;

2. The organization makes no loans to debtors (other than loans with no fees or interest) and does not negotiate the making of loans on behalf of debtors;

3. The organization provides services for the purpose of improving a consumer's credit record, credit history, or credit rating only to the extent that such services are incidental to providing credit counseling services and does not charge any separately stated fee for any such services;

35. I.R.S. Priv. Ltr. Rul. 200450039 (Sept. 14, 2004) (emphasis removed); *See also* I.R.S. Priv. Ltr. Rul. 200450036 (Dec. 10, 2004).

36. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1220, 120 Stat. 780, 1086–1088 (2006).

37. Joint Comm. On Taxation, 109th Cong., General Explanation Of Tax Legislation, at 611.

4. The organization does not refuse to provide credit counseling services to a consumer due to inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of a consumer to enroll in a debt management plan;

5. The organization establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable, allows for the waiver of fees if the consumer is unable to pay, and except to the extent allowed by State law prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or on the projected or actual savings to the consumer resulting from enrolling in a debt management plan;

6. The organization at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling organization or its affiliates) and (c) not more than 49 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees);

7. The organization does not own (except with respect to a section 501(c)(3) organization) more than 35 percent of the total combined voting power of a corporation (or profits or beneficial interest in the case of a partnership or trust or estate) that is in the trade or business of lending money, repairing credit, or providing debt

management plan services, payment processing, and similar services; and

8. The organization receives no amount for providing referrals to others for debt management plan services, and pays no amount to others for obtaining referrals of consumers. [38]

If these requirements were not enough, Section 501(q) further limits the percentage of a credit counseling organization's revenues that may come from payments by creditors of consumers of the organization attributable to the debt management plan services.[39] For credit counseling organizations in existence when Section 501(q) was enacted, the percentage limits phase in over the four taxable years beginning after the first anniversary of the date of enactment, with the ultimate limitation at fifty percent of revenue.[40] New credit counseling organizations formed after enactment of Section 501(q) are subject to the fifty percent limit ab initio.[41]

V. *SOLUTION PLUS, INC. V. COMMISSIONER*

In 2008, the Tax Court issued a memorandum decision denying exemption to an organization that it determined was formed primarily to sell debt management programs.[42] On its facts, the decision is by no means surprising. The organization's application for recognition of exemption claimed that it was organized for educational purposes and that sales of debt management plans would make up only a minimal part of its activities and revenues.[43] The information and documents supplied by the organization showed quite the opposite, that debt management plans would be the focus and bulk of the entity's activities and would be its principal source of revenue.[44] The IRS denied the application; Solution Plus sought a

38. *Id.* at 611–13.
39. *Id.* at 613.
40. The limit is eighty percent for the first taxable year of the organization, beginning after the date which is one year after the date of enactment; seventy percent for the second such taxable year beginning after such date; sixty percent for the third such taxable year beginning after such date; and fifty percent thereafter. *Id.*
41. *Id.*
42. Solution Plus, Inc. v. Comm'r, 95 T.C.M. (CCH) 1097 (2008).
43. *Id.* at 18.
44. *Id.* at 18–20.

declaratory judgment that this denial was erroneous.[45] In granting summary judgment for the IRS, the Tax Court concluded that Solution Plus was not organized exclusively for either educational purposes or charitable purposes and that it would not operate exclusively for charitable purposes.[46] A key basis for its last conclusion was the fact that the organization's "primary activity would be to provide DMPs to the general public for a fee that it hopes to collect from its customers and from its customers' creditors . . . ."[47]

VI. THE CONSEQUENCE TO CREDIT COUNSELING ORGANIZATIONS OF PROVIDING SUBSTANTIAL DEBT-SETTLEMENT SERVICES

The question addressed by this Article assumes that the organizations in question are credit counseling organizations that are properly exempt under Section 501(c)(3). Implicit in this assumption is that such organizations satisfy the organizational test and that their activities, governance structure, and sources of financial support meet the requirements contained in Section 501(q). The precise question, therefore, is whether such an organization may expand its activities to include providing a substantial amount of debt-settlement services and continue to satisfy the operational test for tax exemption.

The Supreme Court has held that "the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."[48]

Providing debt-settlement services is not inherently charitable or educational. As the IRS noted in denying an application for exemption, "No court or Internal Revenue Service ruling has indicated that the sale of debt management plans and debt-settlement services is a charitable activity."[49] Consequently, providing debt-settlement services would cause an organization to fail the operational test unless the activity is either (i)

45. *Id.* at 1–2.
46. *Id.* at 20, 22.
47. *Id.* at 9.
48. Better Business Bureau v. United States, 326 U.S. 279, 283 (1945).
49. I.R.S. Priv. Ltr. Rul. 200450039 (Sept. 14, 2004).

incidental to the organization's principal and exempt purpose or (ii) integral to the accomplish of such purpose.[50]

For an activity to be incidental, it must be of very small scale, at least relative to the activities of the organization as a whole. Consequently, it is possible that a tax-exempt credit counseling organization could expand its activities to include a minimal amount of debt-settlement services, which might be considered incidental to the organization's principal activities. The more important question, however, involves the provision of a substantial amount of debt-settlement services by a credit counseling organization.[51] By definition, such substantial services could not be incidental.

VII. AN ACTIVITY MUST BE NECESSARY TO BE INTEGRAL

The key question, therefore, is whether providing debt-settlement services would be considered integral to a credit counseling organization's exempt, educational purpose. The Tax Court addressed a similar issue in *Pulpit Resource v. Commissioner*.[52] The stated purpose of the organization at issue was:

> To advance religious preaching through publication of sermons and other resources for ministers, priests, and rabbis, and to apply proceeds to purchase of preaching materials for libraries of selected schools of theology.[53]

The organization published and sold by subscription a quarterly journal called Pulpit Resource that contained sermons, sermon outlines, and articles on preaching techniques.[54] The IRS had denied the organization's application for exemption, reasoning that it operated essentially as a commercial publishing venture that specialized in religious content. [55]

50. *See* Consumer Credit Counseling Serv. of Ala., Inc. v. U.S., 78-2 U.S.T.C. 9660 (D.D.C. 1978) (giving a conclusion on whether the agency met the operational test in question).

51. Because of the great demand for debt-settlement services and the resulting magnitude of this industry, if tax-exempt credit counseling organizations provided only minimal amounts of debt-settlement services, these organizations as a group would meet only a small portion of the aggregate demand. For this reason, the relevant inquiry concerns the provision of substantial debt-settlement services by such organizations.

52. 70 T.C. 594 (1978).

53. *Id.* at 596.

54. *Id.* at 597.

55. *Id.* at 601.

The Tax Court disagreed. After reviewing the case law and setting out the tension between Pulpit Resource's exempt purpose and the "commercial or business hue" of its activity, the court explained:

> [W]e must determine whether the nonexempt commercial aspect of the activity was either so independent of the religious purpose or was sufficiently substantial that it cannot be said that petitioner was "operated exclusively" for religious purposes. . . . If the sale of religious literature was an integral part of and incidental to petitioner's avowed religious purpose, that activity may be considered a part of the religious purpose or objective. We find that it was.
>
> Apparently the only way petitioner could accomplish its objective of disseminating sermons to ministers to improve their religious preachings was by selling Pulpit Resource at a price sufficient to pay for its cost and provide Harris with a reasonable salary. It apparently received few, if any, contributions and a contest for best sermons met with little financial success. There is no evidence that petitioner was in competition with any commercial enterprise conducting the same business activity. The market for petitioner's product was so limited in scope that it would not attract a truly commercial enterprise. [56]

The test of whether a non-charitable activity is an integral part of an exempt purpose is thus a test of necessity: could the exempt objective be accomplished only by the activity in question?[57]

The Tax Court revisited this issue and confirmed its analysis in *Living Faith, Inc. v. Commissioner*.[58] The organization seeking exemption in that case operated a vegetarian restaurant and health food store.[59] Its exempt purpose was to advance the teachings of the Seventh-day Adventist Church concerning the significance of diet—specifically, a vegetarian diet and abstention from tobacco, alcohol, and caffeine—in promoting good health, and the importance of good health in promoting virtuous conduct.[60] The court sought to determine whether the non-exempt commercial aspect of the organization's activity—the sale of health foods—was "so independent of the religious

56. *Id.* at 611 (internal citations omitted).
57. *Id.*
58. 60 T.C.M. (CCH) 710 (1990), *aff'd*, 950 F.2d 365 (7th Cir. 1991).
59. *Id.*
60. *Id.*

purpose, i.e., furthering the dietary and health goals of the Seventh-day Adventist religion" that it caused Living Faith to fail the operational test.[61]

Reviewing the relevant authorities, the court focused on whether the activities at issue were an "essential ingredient" in accomplishing the exemption purpose:

> In each of these rulings, the organization performed services which were *required* in order to further the tenets of a particular religion or *necessary* to enable members of a particular religion to observe its principles. By way of contrast, petitioner herein has not shown that its operations were required to further the dietary teachings of the Seventh-day Adventist Church or necessary to enable members of the Seventh-day Adventist Church to comply with its beliefs.[62]

Confirming *Pulpit Resource*, for an activity to be an integral part of an exempt purpose, it must be strictly necessary for the accomplishment of such a purpose.[63]

It is doubtful that the IRS or a court would find the provision of debt-settlement services to be an integral part of a credit counseling agency's exempt purposes. Such purposes are educational and take the form of either public seminars and publications or one-on-one counseling. The educational goals are to help consumers learn to budget and spend appropriately and to make prudent use of consumer credit. There is no necessary connection between services seeking a lump sum, discounted settlement of debts, and the exempt purpose of educating consumers in budgeting and prudent borrowing.[64] It should be understood that many tax-exempt credit counseling agencies have provided their services to the public without debt-settlement services for decades.[65] Consequently, there is no

61. *Id.* (emphasis added).

62. *Id.* (emphasis added).

63. *See* Pulpit Resource v. Comm'r, 70 T.C. 594 (1978) (holding that an organization that prepared and published sermons for use by various clergy was operated exclusively for an exempt purpose).

64. Arguably, the success of debt-settlement services, while plainly benefiting debtors, might even undermine the lessons of prudence and restraint implicitly stressed in the credit counseling agencies' exempt purposes.

65. A comment submitted to the FTC on December 18, 2009, by the Financial Education and Counseling Alliance (FECA), argued that use of "the less-than-full-balance DMP, an educationally-based alternative to the traditional debt-settlement program" would permit tax-exempt credit counseling organizations to expand into providing debt-settlement services without running afoul of Section 501(c)(3). Financial Education and Counseling Alliance, RE: comment re Telemarketing Sales Rule–Debt

credible support for an argument that providing debt-settlement services is an "essential ingredient," a necessary activity without which the exempt educational purposes cannot be accomplished. As a result, the provision of substantial debt-settlement services by a non-profit credit counseling agency would constitute a substantial, non-exempt purpose, causing the entity to fail the operational test for exemption.

VIII. INHERENT COMMERCIALITY

In addition to testing whether an activity is necessary to accomplish the organization's exempt purpose, courts often focus on whether the activity is so inherently commercial that it cannot be integral to an exempt purpose. This analysis is sometimes phrased as a determination of whether nonexempt commercial purposes predominate with respect to the activity in question. The Tax Court has held that "[c]ompetition with commercial firms is strong evidence of the predominance of nonexempt commercial purposes."[66] Similarly, the Court of Claims explained that providing investment advisory services to the public in exchange for money "places plaintiff in competition with other commercial organizations providing

---

Relief Amendments, R411001 *available at* http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00312.pdf. This "new method" seems to be the ivory-billed woodpecker of the debt-resolution forest—more frequently discussed than actually encountered. In response to questions from the FTC, GreenPath, Inc., a member of FECA, acknowledged:

> At this time, only one major creditor offers a less-than-full-balance DMP option. Only a very small number of GreenPath consumers (less than 50) are enrolled in this program, which is provided by that creditor as part of a normal GreenPath DMP (with no additional fees or requirements). *The program does not reduce any principal debt*, but will eliminate a percentage of fees and finance charges. Our understanding is that, since no principal debt is eliminated, the consumer does not have any tax liability."

Letter from Richard A. Bialobrzeski, Director of Government/External Relations and Communication (Jan. 15, 2010) *available at* (http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00321.pdf) (emphasis added). The FECA comment does not explain how "less-than-full-balance DMPs" are essential to the activities of tax-exempt credit counseling organizations in light of their absence from the roster of services that such organizations have long provided. *Id.* Nor does it explain how a program that does not reduce any principal debt would be an adequate replacement for debt-settlement services. *Id.*

66. B.S.W. Group, Inc. v. Comm'r, 70 T.C. 352, 358 (1978). *See also* Airlie Foundation v. I.R.S., 283 F. Supp. 2d 58 (D. D.C. 2003) (relying largely on *BSW Group*, the court concluded that Airlie did not qualify for tax exemption because the entity's charitable and educational activities were incidental to its primary activity of operating a conference center that competed with a number of commercial, as well as non-commercial, entities).

similar services. Plaintiff has chosen to compete in this manner and, as a consequence, plaintiff's activities acquire a commercial hue."[67] The Court of Claims reiterated this analysis in holding that an adoption agency that competed with for-profit agencies did not qualify for tax-exempt status.[68]

Because a variety of for-profit entities, including law firms, have historically provided debt-settlement services, a non-profit credit counseling agency that began offering debt-settlement services would necessarily be competing with commercial firms. Such competition is strong evidence of the predominance of non-exempt purposes in connection with this activity. The manner in which debt-settlement services have been provided up to the present thus creates a significant hurdle to the possibility that provision of such services can be taken over by tax-exempt entities.[69]

IX. IMPERMISSIBLE PRIVATE BENEFIT

In addition to the question of whether providing debt-settlement services would constitute a substantial non-exempt function, the IRS might view debt-settlement services as resulting in an improper private benefit to debtors, which would provide another basis for revocation of exempt status. Private benefit is a separate concept from that of "private inurement": private inurement involves benefit to persons controlling a purportedly tax-exempt entity, while private benefit may cover benefits to outsiders as well as insiders.[70] The presence of either is incompatible with exempt status.

By contrast with debt management plans, which are designed to result in full payment of the amounts owed, debt-settlement services seek to discharge debtors' obligations for less than the

67. American Institute for Economic Research v. U.S., 302 F.2d 934, 938 (Ct. Cl. 1962).

68. Easter House v. U.S., 60 A.F.T.R. 2d 87-5119 (Cl. Ct. 1987).

69. If the for-profit debt-settlement service providers are driven out of business by an advance fee ban, a tax-exempt credit counseling organization that began providing such services might argue that it was not currently competing with commercial businesses. Because the demise of the commercial providers would have resulted from the tax-exempt entities prevailing on the FTC to regulate their competition out of business, a court might not view the tax-exempt entities as having sufficiently clean hands to make such an argument.

70. I.R.S. Chief Couns. Mem. 200431023 (July 30, 2004), *available at* http://www.irs.gov/pub/irs-wd/0431023.pdf; *See also* American Campaign Academy v. Comm'r., 92 T.C. 1053, 1064 (1989).

full principal amount. Accomplishment of this goal results in taxable income to the debtors.[71] The recipients of debt-settlement services are not exclusively impoverished; indeed, many of them are persons of more moderate means who have become overburdened with consumer debt for a variety of reasons. In a number of similar contexts, the IRS and the courts have found the presence of private benefits to preclude exemption under section 501(c)(3).[72]

For example, the Tax Court has denied tax-exempt to an organization that sought to increase charitable contributions to exempt entities by providing tax and estate planning advice to donors, because the court reasoned that the tax and estate planning advice provided a private benefit to donors that was inconsistent with exempt status.[73] Four years later, the Tax Court carried out a similar analysis in denying exemption to an entity that operated for the purpose of promoting litigation to protect pension funds of retired New York City teachers, where a significant factor to the court's finding of impermissible private benefit was the fact that over two-thirds of retirees were not poor.[74] By contrast, the Tax Court found no impermissible private benefit in the case of an organization importing and selling handicrafts where only an insubstantial number of the artisans who made these handicrafts were not disadvantaged.[75]

71. I.R.C. § 61(a)(12) (1984).

72. I.R.C. § 501(c)(3) (2006).

73. Christian Stewardship Assistance v. Comm'r, 70 T.C. 1037 (1978). The IRS employed a similar analysis in concluding that:

> [a]n association of investment clubs formed to enable members and prospective investors to make sound investments by the mutual exchange of investment information, that carries on not only educational activities but other activities directed to the support and promotion of the economic interests of its members, does not qualify for exemption."

Rev. Rul. 76-366, 1976-2 C.B. 144. The basis for this conclusion was that "the association is serving private interests." *Id.* An extreme example of disqualifying private benefit is found in *Ecclesiastical Order of Ism of Am v. Comm'r.* 80 T.C. 833 (1983). In that case, the Tax Court denied tax exemption to an organization that recruited new members by emphasizing the tax benefits of becoming a minister in its "religion" and whose "educational" literature emphasized tax avoidance.

74. Retired Teachers Legal Defense Fund, Inc. v. Comm'r, 78 T.C. 280 (1982).

75. Aid to Artisans, Inc. v. Comm'r, 71 T.C. 202 (1978).

X. STRINGENT APPLICATION OF EXEMPTION REQUIREMENTS TO CREDIT COUNSELING ORGANIZATIONS CONTINUES

Many tax-exempt credit counseling organizations likely welcomed the enactment of Section 501(q). Its provisions provided bright-line guidance that removed the uncertainty and the apparently mounting risk to exempt status arising out of the receipt of "fair share" payments from credit card companies. Since enactment of section 501(q), it has become apparent that this action by Congress did not cause an about-face in the attitude of the IRS toward credit counseling organizations claiming tax exemption.

In a 2008 private letter ruling denying exempt status, the IRS again cited *Credit Counseling Centers, Inc. v. City of South Portland* after a four-year absence from such rulings.[76] Although section 501(q) appears to have solved the problem of what portion of a credit counseling organization's revenues may come from fair share payments, it does not address the argument that credit card companies derive an impermissible private benefit from the activities of organizations with an excessive focus on debt management plans, particularly if the eligibility criteria for such plans appear designed more for the creditors' benefit than the debtors'. The return of allusions to *South Portland* may hint at interest on the part of the IRS to further develope of this line of analysis.

On February 15, 2010, Marcus S. Owens, a former director of the Exempt Organizations Division of the IRS who is now in private practice, took the unusual step of publicly releasing a letter he wrote to Diane Ryan, the Chief of the IRS Appeals Office.[77] Owens wrote to complain of the refusal by the Appeals

76. I.R.S. Priv. Ltr. Rul. 200851024 (Aug. 5, 2008) (citing *Credit Counseling Centers, Inc. v. City of South Portland*, 814 A.2d 458, 460 (Me. 2003)). As in the earlier rulings, this denial of exempt status determined that the applicant:

> [P]rovides substantial private benefits" to credit card companies in a manner similar to the organization in *Credit Counseling Centers v. S. Portland*. *Id.* at Issue 3. Fair share is commonly defined as "that amount the organization receives from the creditors for each payment remitted to them." In the absence of any charitable or meaningful educational activities, which we have established, you are operating as a collection agency for these companies. The "fair share" paid by the credit card companies would undoubtedly result in significant savings over the possible costs of not recovering any of the unpaid debt owed them. Thus, these companies clearly realize substantial financial benefits through your collection activities.

Id. at 159–160.

77. Tax Analysts Document Serv., Doc. 2010-3163.

Office "to seek Technical Advice regarding whether, in light of the enactment of section 501(q) and the holdings of Consumer Credit Counseling Service of Alabama and Credit Counseling Centers of Oklahoma, debt management programs (DMPs) conducted by credit counseling organizations qualify as a charitable activity." It appears from Owens' letter that both the examining agent and the Appeals Office had concluded that debt management programs do not qualify as a charitable activity.

Notwithstanding Owens' indignation, this should hardly be surprising, as it represents a continuation of the view that the IRS expressed in Private Letter Ruling 200450039.[78] Section 501(q) imposes additional requirements for certain types of organizations that otherwise qualify under Section 501(c)(3).[79] Section 501(q) is not, however, a safe harbor whose requirements, if complied with, make it unnecessary for an organization to meet the various common-law requirements that courts have constructed under Section 501(c)(3).[80] Nothing in Section 501(q) suggests that debt management programs are viewed as a charitable activity. To the contrary, Section 501(q) makes it clear that it applies to "organization[s] with respect to which the provision of credit counseling services is a substantial purpose," i.e., it is the educational, credit-counseling function that is the charitable activity upon which exemption may be

78. I.R.S. Priv. Ltr. Rul. 200450039 (Dec. 10, 2004). As noted above, that ruling states, "No court or IRS ruling has indicated that the sale of [debt management plans and debt-settlement services] is a charitable activity." *Id.* at 148. Similarly, the IRS observed in Chief Counsel Advisory 200431023 that "[d]ebt management, like the adoption services in Easter House, is not a traditionally charitable activity." I.R.S. Chief Counsel Advisory 200431023 (July 30, 2004).

79. Section 501(q)(1) begins: "An organization with respect to which the provision of credit counseling services is a substantial purpose shall not be exempt from tax under subsection (a) *unless such organization is described in paragraph (3) or (4) of subsection (c) and* such organization is organized and operated in accordance with the following requirements: . . ." I.R.C. § 501(q) (2000) (emphasis added).

80. The legislative history of 501(q) says just that with respect to the revenue percentage standards for income from creditors:

> Compliance with the revenues test does not mean that the organization's debt management plan services activity is at a level that organizationally or operationally is consistent with exempt status. In other words, satisfaction of the aggregate revenues requirement (as a preliminary matter in an exemption application, or on an ongoing operational basis) provides no affirmative evidence that an organization's primary purpose is an exempt purpose, or that the revenues that are subject to the limitation (or debt management plan services revenues more generally) are related to exempt purposes.

Joint Comm. On Taxation, 109th Cong., General Explanation Of Tax Legislation, at 613.

based.[81] In addition, Owens' argument that debt management programs themselves constitute a charitable activity is inconsistent with the Tax Court's decision in *Solution Plus*.[82]

Given the apparent unwillingness of the IRS to reverse its longstanding view that the provision of debt management plans is not itself a charitable activity, it seems very unlikely that the IRS would countenance a significant expansion into providing debt-settlement services on the part of entities claiming tax exemption.

XI. CONCLUSION

For the foregoing reasons, the provision of substantial debt-settlement services by credit counseling agencies that are currently exempt under section 501(c)(3) would likely place such organizations outside the exemption provided by section 501(c)(3) of the Code. Few credit counseling agencies would be likely to risk their exempt status, and the freedom from FTC oversight that accompanies it, in order to begin providing significant amounts of debt-settlement services. If the FTC expands the Telemarketing Sales Rule in the ways set out in the Notice of Proposed Rulemaking, and if the advance fee ban then puts a large number of for-profit debt-settlement providers out of business, it appears likely that the significant demand for debt-settlement services among consumer debtors will go largely unmet.

81. I.R.C. 501(q)(2)

82. Owens' letter does not refer to *Solution Plus*. It is perhaps part of what Owens describes as the "unidentified"—and, from our perspective, nonexistent—judicial precedent upon which the Appeals Office relied. Tax Analysts Document Serv., Doc. 2010-3163.

"HID[ING] ELEPHANTS IN MOUSEHOLES":[*] THE FTC'S UNWARRANTED ATTEMPT TO REGULATE THE DEBT-RELIEF-SERVICES INDUSTRY USING RULEMAKING AUTHORITY PURPORTEDLY GRANTED BY THE TELEMARKETING AND CONSUMER FRAUD AND ABUSE PREVENTION ACT

MICHAEL THURMAN & MICHAEL L. MALLOW[**]

* Am. Bar Ass'n v. Fed. Trade Comm'n, 430 F.3d 457, 467 (D.C. Cir. 2005) (quoting Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 468 (2001)). Circuit Judge David B. Sentelle used this phrase in response to the FTC's argument that by making the Gramm–Leach–Bliley Financial Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338, applicable to "'institutions'" that are "'engaged in the business of financial activity,'" Congress authorized the FTC to regulate attorneys. *Id.* at 467. Judge Sentelle state: "we are reminded repeatedly of a recent admonition from the Supreme Court: [Congress] does not . . . hide elephants in mouseholes." *Id.*

** Mr. Thurman and Mr. Mallow are partners in the Litigation Department of Loeb & Loeb, LLP, in Los Angeles, California. They regularly counsel and defend individuals and companies in investigations and actions brought by the Federal Trade Commission and state regulators. Mr. Thurman received his J.D. from the University of Oregon School of Law in 1985 and an A.B. degree from Stanford University in 1979. Mr. Mallow obtained his J.D. with Honors from George Washington University Law School in 1991 and a B.A. degree from State University of New York at Binghamton in 1988.

I. INTRODUCTION

Over the past four decades, the Federal Trade Commission (FTC) has engaged in an aggressive campaign to expand its administrative enforcement and rulemaking authority over businesses and individuals in the areas of consumer protection and antitrust regulation. Sparked by a 1969 American Bar Association (ABA) report that took the agency to task for failing to achieve the ambitious goals of its early twentieth-century designers,[2] the FTC transformed its public perception from toothless in 1969[3] to tyrannical by 1980.[4] During that time the agency developed a strategic policy, which continues to be employed today, of pushing the envelope of its authority in the name of its enormously broad charge to prevent "unfair competition"[5] and "unfair or deceptive acts or practices."[6]

The agency's latest foray into the uncharted and undefined waters of undelegated authority is its initiative to amend the Telemarketing Sales Rule (TSR)[7] to add a wide-ranging set of new regulations[8] targeted at the debt-relief-services industry.[9] Oddly, these proposed new rules were announced to the public shortly after Congress began considering proposed legislation

2. COMM'N TO STUDY THE FED. TRADE COMM'N, AM. BAR ASS'N, REPORT OF THE ABA COMMISSION TO STUDY THE FEDERAL TRADE COMMISSION (1969) [hereinafter ABA REPORT].

3. In 1969, a typical criticism was that the agency was "rudderless; poorly managed and poorly staffed; obsessed with trivia; politicized; all in all, inefficient and incompetent." Richard Posner, *The Federal Trade Commission*, 37 U. CHI. L. REV. 47, 47 (1969).

4. By 1981, Congressional critics accused the FTC of being "'a renegade agency,'" a "'bureaucratic agency that is out to destroy free enterprise,'" and "'a rogue agency gone insane.'" William E. Kovacic, *Congress and the Federal Trade Commission*, 57 ANTITRUST L.J. 869, 870 (1989) (citations omitted).

5. *Id.* at 880.

6. Federal Trade Commission Act of 1914 § 5(a)(2), 15 U.S.C. § 45(a)(2) (2006).

7. FTC Telemarketing Sales Rule, 16 C.F.R. §§ 310.1–.9 (2009). In 1994 Congress authorized the FTC to adopt the TSR in the Telemarketing and Consumer Fraud and Abuse Prevention Act (TCFPA). 15 U.S.C. §§ 6101–6108. This act authorized the FTC to regulate abusive telemarketing. *Id.* § 6102(a)(1) ("The Commission shall prescribe rules prohibiting deceptive telemarketing acts or practices and other abusive telemarketing acts or practices.").

8. FTC Notice of Proposed Rulemaking, 74 Fed. Reg. 41,988 (proposed Aug. 19, 2009) [hereinafter FTC NPRM].

9. *See* discussion *infra* Part III.

regulating the debt-relief industry.[10] Rather than wait for the Legislature's express guidance, the agency has elected to pursue its own rulemaking, purportedly based on its existing regulatory authority. However, the proposed regulations have little to do with telemarketing,[11] begging the question: why would the FTC resort to the TSR as a rulemaking device given its broad rulemaking authority provided by the Magnuson–Moss Warranty Federal Trade Commission Improvement Act?[12]

The answer to this question is both obvious and troubling. The FTC's attempt to sidestep its statutory rulemaking requirements under Magnuson–Moss, and instead use the more expeditious notice and comment provisions of the TSR, raises important constitutional questions. Some might argue that this solution reflects a nimble and pragmatic response to the challenge of effectively regulating businesses in the Internet age. However, another perspective is that the agency has gone too far in its zeal to fulfill its mission and that it routinely engages in the same conduct for which it prosecutes individuals and companies: namely, failing to comply with the law.

This Article examines the background and history of the FTC's late twentieth-century activism leading up to the current Administration. It reviews the basis and limitations of the agency's rulemaking authority, both under the Federal Trade Commission Act of 1914 (FTC Act) and the Telemarketing and Consumer Fraud and Abuse Prevention Act (TCFAPA). This Article also looks at the debt-relief-services industry and the nature of the proposed regulations that have been advanced by

10. In May 2009, Rep. Bobby Rush (D-IL) introduced the "Consumer Credit and Debt Protection Act." *See* Consumer Credit and Debt Protection Act, H.R. 2309, 111th Cong. (2009). The proposed statute would grant the FTC authority to utilize the expedited rulemaking procedures of the Administrative Procedures Act ("APA") concerning consumer credit or debt and would direct the FTC to examine and promulgate rules with regard to debt settlement. The proposed Act would also allow the FTC to seek civil penalties up to $10,000 per violation for "unfair or deceptive acts practices in connection with consumer credit or debt." *Id.*

11. "Telemarketing" is defined in the TSR as "a plan, program, or campaign which is conducted to induce the purchase of goods or services or a charitable contribution, by use of one or more telephones and which involves more than one interstate telephone call." 16 C.F.R. § 310.2(cc).

12. *See, e.g.*, 15 U.S.C. § 2302(b)(1)(A) (2006) ("The Commission shall prescribe rules requiring that the terms of any written warranty on a consumer product be made available to the consumer (or prospective consumer) prior to the sale of the product to him."); *id* § 2306(a) ("The Commission may prescribe by rule the manner and form in which the terms and conditions of service contracts shall be fully, clearly, and conspicuously disclosed.").

the FTC to govern debt-relief-services companies. Finally, this Article examines the application of the TSR rulemaking provisions to the debt-relief-services industry and discusses why the telemarketing statute is unsuitable for the FTC's proposed rulemaking.

II. THE HISTORY AND BACKGROUND OF THE DEVELOPMENT OF THE FTC'S LATE TWENTIETH-CENTURY ACTIVISM

"To many, [the FTC's] comparative inefficiency will seem scandalous, but one could regard it as the agency's saving grace."[13]

The FTC was created by Congress in 1914[14] in response to growing concerns from the public and industry about unfair methods of competition in the channels of interstate trade.[15] The FTC Act created the Commission[16] and prohibited unfair business practices.[17] The Act also granted the Commission authority to institute administrative proceedings against any person, partnership, or corporation that it had reason to believe was using unfair methods of competition in commerce and to issue cease-and-desist orders enjoining violators from continuing the alleged unlawful activities.[18]

The FTC Act declared that "unfair methods of competition in or affecting commerce" are unlawful.[19] However, the statute also granted the Commission authority to establish rules defining the nature of unfair methods of competition in accordance with the usages, customs, and practices of specific industries and businesses.[20] The new Act provided an additional source of protection to business entities that were injured as a result of unfair competition. Before the Act's passage, injured parties were limited to remedies provided in civil lawsuits: seeking injunctive relief or damages in response to unfair

13. Posner, *supra* note 3, at 87.
14. Federal Trade Commission Act of 1914, 15 U.S.C. § 41 (2006).
15. RALPH L. NELSON, MERGER MOVEMENTS IN AMERICAN INDUSTRY, 1895–1956, at 37 (1959). From 1898 to 1902, at least 303 firms disappeared annually through mergers. *Id.* at 37 tbl. 14. In the three years prior, only sixty-nine or fewer firms had disappeared annually through consolidations. *Id.*
16. 15 U.S.C. § 41.
17. *Id.* § 45(a)(1).
18. *Id.* § 45(b).
19. 15 U.S.C. § 45(a)(1).
20. *Id.* §§ 57(a)(1)(A)–(B).

competitive practices.[21] The Act gave injured competitors the alternative to seek the assistance of the Commission, which was authorized to impose cease and desist orders that were enforceable by the federal courts.[22]

In 1938, Congress strengthened and expanded the Commission's jurisdiction by adopting the Wheeler–Lea Act of 1938,[23] which amended the Act to add a prohibition against "unfair or deceptive acts or practices in commerce." Wheeler–Lea was the Legislature's response to a series of court decisions holding that before the Commission could prohibit an "unfair" practice, it must prove injury to an actual or potential competitor.[24] The amendment effectively made injury to the public a sufficient basis for Commission action.[25] Additionally, besides retaining the original ban against "unfair methods of competition," the amendment added a prohibition against "unfair or deceptive acts or practices in commerce,"[26] thus laying the foundation of the Commission's consumer protection authority.

Thirty years later, the FTC Act's promise—that the Commission would utilize its powers to control unfair business competition and unfair and deceptive treatment of consumers—had all but vanished. The political atmosphere of the 1960s had inspired challenges to a wide variety of American institutions.[27] The FTC, which had been subjected to ongoing criticism almost since its inception,[28] was once again under attack.[29] Professor

21. Federal Trade Commission, Annual Report of the Federal Trade Commission 16 (1930).

22. *Id.*

23. Act of March 21, 1938, ch. 49, 52 Stat. 111 (codified as amended in scattered sections of 15 U.S.C.).

24. FED. TRADE COMM'N, ANNUAL REPORT OF THE FEDERAL TRADE COMMISSION 2 (1950).

25. *Id.*

26. Ch. 49, sec. 3, § 5(a), 52 Stat. at 111 (codified as amended at 15 U.S.C. 45(a)(1) (2006)).

27. *E.g.*, John Roos, *American Political Life in the 1960s: Change, Recurrences, and Revolution*, 34 REV. OF POL., 44, 44 (1972).

28. Edward F. Cox, a member of the team of young intellectuals known as "Nader's Raiders," identified studies published in 1924, 1949, and 1960 that criticized the FTC for "the staff's focus on trivia without attention to priorities, the related lack of planning and involvement in protracted meaningless litigation, a tolerance for mediocre staff, and a culture of secrecy." Edward F. Cox, *Reinvigorating the FTC: The Nader Report and The Rise of Consumer Advocacy*, 72 ANTITRUST L.J. 899, 900 n.6 (2005).

29. *See, e.g.*, Posner, *supra* note 3, at 87 ("To many, [the FTC's] comparative inefficiency will seem scandalous, but one could regard it as the agency's saving grace.")

Richard Posner's views were typical of those expressed by the FTC's critics. In September 1969, Posner wrote, "The Commission is rudderless; poorly managed and poorly staffed; obsessed with trivia; politicized; all in all, inefficient and incompetent. And—the persistence of all of these criticisms would seem to indicate—largely impervious to criticism."[30] Others complained that the agency needed "some kind of an injection to pep it up so it would fulfill its mission."[31]

In early January 1969, Ralph Nader and his "raiders" released an updated critique of the FTC.[32] Shortly after the Nader report was published, newly elected President Richard M. Nixon responded with a request to the President of the American Bar Association (ABA) for "a professional appraisal of the present efforts of the Federal Trade Commission in the field of consumer protection."[33] The ABA assembled a top-notch commission of FTC practitioners and scholars, which delivered its report in September 1969.[34]

The ABA Report recounted the agency's problems that had been identified in the previous studies, including: "poor management, inadequate planning, weak personnel and cumbersome procedures."[35] The ABA report stated that an FTC bureau chief responsible for recruiting believed "young lawyers are not competent to engage in both trial and investigative work" and that "[the bureau chief] preferred to hire older men—who had been out in the world for ten years or so and had come to appreciate that they were not going to make much of a mark—because they tended to be loyal and to remain with the FTC."[36] The bureau chief gave "less weight" to "law school grades than to other factors."[37] The ABA Commission concluded, "'If there is a formula better designed to avoid hiring

30. *Id.* at 47.

31. *Nomination of Lewis A. Engman to be a Commissioner, Federal Trade Commission: Hearing Before the S. Comm. on Commerce*, 93d Cong. 25 (1973) [hereinafter *Engman Confirmation Hearings*].

32. EDWARD F. COX ET AL., THE NADER REPORT ON THE FEDERAL TRADE COMMISSION 180 (1969).

33. Letter from Richard M. Nixon, President, U.S., to Bernard G. Segal, President, Am. Bar Ass'n (Apr. 18, 1969), *in* ABA REPORT, *supra* note 2, at app. 1, 86.

34. ABA REPORT, *supra* note 2.

35. Kovacic, *supra* note 4, at 877.

36. ABA REPORT, *supra* note 2, at 33.

37. *Id.*

bright and energetic young men, we have not heard of it.'"[38] The ABA Report challenged the Commission to focus its antitrust enforcement activities on "economically significant problems" and "complex, unsettled areas of law and economics." The report exhorted the agency to curtail or eliminate its reliance on "voluntary enforcement strategies" and instead to implement "binding, compulsory techniques."[39]

Some, however, including ABA Committee member Professor Richard Posner, in his dissent to the ABA Report, seriously questioned whether the FTC experiment should not be written off as a failure. Rather than encourage the agency to improve upon its execution of Congress's vision, Posner "essentially proposed the dismemberment and abolition of the FTC."[40]

In addition to initiating the ABA Report, President Nixon also appointed Casper Weinberger as FTC Chairman in 1969.[41] Nicknamed "Cap The Knife," Weinberger immediately implemented planning, recruiting, and organizational evaluation initiatives that launched a cultural transformation at the agency.[42] By 1973, as Congress confirmed a new FTC chairman, legislators were already expressing confidence that the agency had taken significant steps toward revival. Senator Frank Moss said "the Commission has taken on new life beginning with the search for strong and imaginative, rigorous developers and enforcers of the law."[43] Moss expressed his approval that the agency had "stretched its powers to provide a credible countervailing public force to the enormous economic power of huge corporate conglomerates which dominate American enterprise."[44] Senator Ted Stevens exhorted the new chairman to reach further: "I am really hopeful that you will become a real zealot in terms of consumer affairs and some of these big business people will complain to us that you are going too far. That would be the day as far as I'm concerned."[45]

38. Arthur John Keefe, *Is The Federal Trade Commission Here to Stay?*, 56 A.B.A. J. 188 (1970).
39. Kovacic, *supra* note 4, at 874.
40. Cox, *supra* note 28, at 908.
41. *Id.* at 906.
42. *Id.*
43. *Engman Confirmation Hearings*, *supra* note 31, at 4.
44. *Id.*
45. *Id.* at 31.

In 1974, Congress granted the agency additional enforcement authority when it passed provisions in the Trans-Alaska Pipeline Authorization Act,[46] that empowered the FTC to enforce administrative cease and desist orders with federal court injunctions. Section 13(b) of the FTC Act allowed the agency to seek temporary restraining orders and preliminary injunctions and, in proper cases, permanent injunctions "to halt" violations of the FTC Act.[47] In 1975, Congress granted the FTC formal rulemaking authority and provided additional weapons to the FTC's enforcement arsenal in the Magnuson–Moss Act.[48] Later in that year, the same Congress enacted Section 19,[49] cautiously expanding FTC powers by authorizing the Commission to bring civil actions seeking a broad array of legal and equitable monetary remedies where it establishes that a person (1) violated an FTC rule respecting unfair or deceptive practices[50] or (2) engaged in an unfair or deceptive act or practice that was the subject of a previously issued cease and desist order—"which a reasonable man would have known under the circumstances was dishonest or fraudulent."[51]

Armed with more talented and aggressive lawyers and new statutory weapons from Congress, the FTC went on the offensive. Within just five years of the passage of Magnuson–Moss, the zealotry that Senator Stevens had wished for in 1973 was now the prevailing theme of attacks against the agency mounted not only by "big business" but by Congress itself. "Generated by an array of far-reaching FTC law enforcement, rule-making, and data-collection programs, a tidal wave of business opposition to the agency swept over Capitol Hill."[52]

46. Pub. L. No. 93-153, 87 Stat. 584 (1973) (codified as amended in scattered sections of 5, 12, 15, 33, 42, 43, and 46 U.S.C.)

47. *Id.* sec. 408(f), §§ 13(b)(1)–(2), 87 Stat. at 592 (codified as amended at 15 U.S.C. § 57(b)(1)–(2) (2006)).

48. *See, e.g.*, 15 U.S.C. § 2302(b)(1)(A) (2006) ("The Commission shall prescribe rules requiring that the terms of any written warranty on a consumer product be made available to the consumer (or prospective consumer) prior to the sale of the product to him."); *id* § 2306(a) ("The Commission may prescribe by rule the manner and form in which the terms and conditions of service contracts shall be fully, clearly, and conspicuously disclosed.").

49. Magnuson–Moss Warranty–Federal Trace Commission Improvement Act, Pub. L. No. 93-637, sec. 206(a), § 19, 88 Stat. 2183 (1975) (codified as amended at 15 U.S.C. § 57b (2006)).

50. *Id.* § 19(a)(1) (codified as amended at 15 U.S.C. § 57b(a)(1)).

51. *Id.* § 19(a)(2) (codified as amended at 15 U.S.C. § 57b(a)(2)).

52. Kovacic, *supra* note 4, at 870.

Members of Congress accused the FTC of being "'a renegade agency,'"[53] a "bureaucratic agency that is out to destroy free enterprise,"[54] and "a rogue agency gone insane."[55]

In 1980, Congress attempted to reign in the agency with the Federal Trade Commission Improvements Act of 1980,[56] which contained numerous provisions curtailing the FTC's powers.[57] Senator Howard Cannon described the Act's background as follows:

> The real reason that we have proposed this legislation for the FTC is because the Commission appeared to be fully prepared to push its statutory authority to the very brink and beyond. The FTC lost sight of the necessity to listen to the evidence and legal arguments of its opponents. Good judgment and wisdom had been replaced with an arrogance that seemed unparalleled among independent regulatory agencies. The FTC brought this legislation upon itself because its own chairman sought to 'venture in the unchartered [sic] territory' of the Federal Trade Commission Act.[58]

But the genie was now out of the bottle. Beginning in the early 1980s, the FTC shifted its focus to expanding the reaches of its statutory authority through the Judiciary. Exploiting cases that involved egregious wrongdoing by various defendants,[59] the

53. *Id.* (citation omitted).

54. 126 Cong. Rec. 6,707 (1980) (statement of Rep. Quillen).

55. 125 Cong. Rec. 32,350 (1979) (statement of Rep. Frenzel).

56. Pub. L. No. 96-252, 94 Stat. 374 (1980) (codified as amended in scattered sections in 15 U.S.C.).

57. *See, e.g.*, *id.* sec. 7, § 18(a)(1)(B) (codified at 15 U.S.C. § 57a(a)(1)(B) (2006)) ("[T]he Commission shall not develop or promulgate any trade rule or regulation with regard to the regulation of the development and utilization of the standards and certification activities pursuant to this section."); *id.* sec. 8, § 18(b)(2)(A) (codified at 15 U.S.C. § 57a(b)(2)(A)) ("Prior to the publication of any notice of proposed rulemaking pursuant to paragraph (1)(A), the Commission shall publish an advance notice of proposed rulemaking in the Federal Register.").

58. 126 Cong. Rec. 11,917 (1980).

59. The Director of the Bureau of Consumer Protection recently described this activist strategy as follows:

> [P]art of our job is to be stewards of the statutes that we have to implement. And if we think the law says X, but there isn't a case that establishes X and people are not conforming their conduct to our belief about how the law ought to work, then we should look for a good case to establish X as a governing legal principle. I would define the term 'test case' as a case in which the facts directly and clearly support the legal theory that you are advocating, even if the legal theory has not been accepted by a court prior to that time. And you bring a test case to see whether you can persuade the court to adopt your reading of the law.

agency slowly and meticulously undertook a concerted and deliberate campaign to expand the remedies available under Section 13(b) of the FTC Act without Congressional approval.[60] The Commission understandably found the injunctive remedies available in Section 13(b) to be particularly valuable tools because they enable the Commission "to obtain an order not only permanently barring deceptive practices, but also imposing various kinds of monetary equitable relief (i.e., restitution and disgorgement) to remedy past violations."[61]

The FTC accomplished this unauthorized expansion of Section 13(b) by convincing courts that "equitable" monetary relief could include expanded forms of "restitution" and "disgorgement" against defendants accused of violating Section 5 of the FTC Act, which prohibits "unfair or deceptive acts or practices."[62] The FTC persuaded the courts to make these awards based on two older Supreme Court decisions that authorized the use of the courts' "inherent equity powers" to award monetary relief to enforce compliance with non-FTC-related statutes "in the absence of a clear and valid command" from Congress restricting such powers.[63]

In *FTC v. H.N. Singer, Inc.*,[64] the agency successfully argued that the FTC Act authorized the federal court to utilize the full array of equitable remedies at its disposal in Section 13(b) cases. The FTC pressed the Ninth Circuit to rule (in dicta) that the court's "inherent equity powers" authorized the award of monetary relief in the form of equitable rescission for Section 5 violations.

59. John Villafranco, *Interview with David Vladeck, Director, FTC Bureau of Consumer Protection*, The Antitrust Source, Vol. 9, Issue 4 (Apr. 2010), http://www.abanet.org/antitrust/at-source/10/04/Apr10-VladeckIntrvw4-14f.pdf.

60. For detailed retelling of the FTC's campaign to expand the reach of Section 13(b) by a former FTC attorney, see David M. FitzGerald, The Genesis of Consumer Protection Remedies Under Section 13(b) of the FTC Act (Sept. 23, 2004), http://www.ftc.gov/ftc/history/docs/fitzgeraldremedies.pdf.

61. FTC Office of the General Counsel, A Brief Overview of the Federal Trade Commission's Investigative and Law Enforcement Authority, http://www.ftc.gov/ogc/brfovrvw.shtm (last visited May 26, 2010).

62. FitzGerald, *supra* note 60, at 16–17.

63. *See* Mitchell v. Robert DeMario Jewelry, Inc., 361 U.S. 288, 291 (1960) (holding that unless a statute actually or by necessary and inescapable inference restricts the Court's jurisdiction in equity, the full scope of the Court's equitable jurisdiction is to be recognized and applied); Porter v. Warner Holding Co., 328 U.S. 395, 398 (1946) (holding that where the public interest is involved the Court's equitable powers are even broader and of a more flexible character).

64. 668 F.2d 1107 (9th Cir. 1982).

Although the *Singer* decision paved the way for subsequent decisions that accepted the argument that Section 13(b) authorized the courts to award monetary relief in Section 5 actions, the new line of cases was flawed from the beginning as a result of several defects in the court's analysis.

First, the only issues that were presented in *Singer* were the trial court's authority to enjoin the defendants from committing further violations of the Franchise Trade Rule, to freeze their assets, and to require an accounting (all of which were consistent with legitimate Section 13(b) objectives of preserving the status quo pending the completion of the FTC's administrative process). There was no need or reason for the Ninth Circuit to reach the question whether any equitable remedies were available under Section 13(b) beyond the injunction, freeze order and accounting issues that were presented. The FTC had separately sought Section 19 relief, which provided for the monetary remedies of rescission, restitution and refund. The court's determination that it had authority to maintain the status quo by ordering the injunction, freeze and accounting based on the legislative intent of Section 13(b) was all that was required where all of the other monetary remedies that were sought by the FTC were expressly provided by Section 19.

Second, the *Singer* court reviewed only enough of the legislative history to make the correct determination that "The purpose of [Section 13(b)] is to permit the Commission *to bring an immediate halt* to unfair or deceptive acts or practices when to do so would be in the public interest."[65] But the court disregarded clear indications of legislative intent when it held that application of the court's equitable powers, including rescission and restitution, was consistent with the stated purpose of the statute. In reaching this decision, the Ninth Circuit failed to consider the more complete analyses of the statutory history performed by the Fifth Circuit in *FTC v. Southwest Sunsites, Inc.*,[66] and the D.C. Circuit in *FTC v. Weyerhaeuser Company*.[67]

Relying on the Ninth Circuit's dicta in *Singer*, the agency continued its campaign to unilaterally expand its power to obtain monetary relief under Section 13(b) in other circuits,

65. 668 F.2d at 1111 (quoting S. Rep. 93-151, p. 30-31) (emphasis added).
66. 665 F.2d 711 (5th Cir. 1982).
67. 665 F.2d 1072 (D.C. Cir. 1981).

often selecting cases involving unrepresented defendants[68] and/or egregiously deceptive and fraudulent conduct.[69] Generally, these cases were brought against the direct perpetrators of those schemes where the consumer loss was directly equal to the defendants' gains.[70] Consequently, the issues regarding statutory interpretation were often not raised at all or the courts were apparently dissuaded by the FTC from closely scrutinizing the agency's authority to obtain monetary relief based on Section 13(b). Had a more careful statutory analysis been performed, the courts should have and likely would have rejected the FTC's assertion that Section 13(b) allows for consumer redress based on: (1) the express language of Section 13(b) itself, (2) the legislative history of the FTC Act and the amendments that added Sections 13(b) and 19(b) in the mid-1970s, and (3) the decisions that first interpreted Section 13(b) after it was amended.[71]

Significantly, the Supreme Court has subsequently refused to imply equitable remedies in statutes where Congress has established—"elaborate enforcement provisions" similar to,

68. *E.g.*, Fed. Trade Comm'n v. Stefanchik*,* 559 F.3d 924, 931 (9th Cir. 2009).

69. FTC v. Gem Merch. Corp., 87 F.3d 466, 469–70 (11th Cir. 1996) (telemarketers lured customers by misrepresenting terms, conditions and likelihood of winning prizes consumers would receive if they consumer purchased medical alert systems);. FTC v. Pantron I, 33 F.3d 1088 (9th Cir. 1994) (no scientifically reliable evidence (other than "placebo effect") supporting claim that defendant's Helsinki Formula baldness treatment, consisting of a shampoo and conditioner promoted hair growth or prevented hair loss); FTC v. Security Rare Coin & Bullion, 931 F.2d 1312, 1316 (8th Cir. 1991) (marketers misrepresented the value and risk of collectible coins as excellent low-risk investments with superior liquidity and profit potential when in fact the company arbitrarily marked up the price of the coins two or three times the wholesale price, such that the coins would have to double or triple in value before any gain could be realized); FTC v. Amy Travel Service, Inc., 875 F.2d 564 (7th Cir. 1989) (misleading telemarketing of approximately 35,000 travel vouchers from $289 to $328 that actually had little value to consumers); FTC v. World Travel Vacation Brokers, Inc., 875 F.2d 1020, 1026 (7th Cir. 1988) (sold more than 600,000 vacation certificates purporting to provide airfare to Hawaii for $29, yet actually charged consumers hundreds of dollars for full airfare and hotel rates).

70. *See, e.g*, Fed. Trade Comm'n v. Stefanchik*, supra* note 68.

71. A prominent attorney working for Ropes & Gray in Washington, D.C., has recognized that "the Commission's general authority to employ § 13(b) beyond the right to seek injunctive relief remains poised on relatively narrow legal footing." James M. Spears, Comment for Federal Trade Commission, Mar. 29, 2002, at 6, http://www.ftc.gov/os/comments/disgorgement/spearsjamesm.pdf; *see also Government Civil Liberties: Hearing before the Antitrust Modernization Comm.* 13 n.24 (2005) (statement of Kevin Arquit, Partner, Simpson Thatcher & Bartlett), *available at* http://govinfo.library.unt.edu/amc/commission_hearings/pdf/Statement_Arquit.pdf ("While at one time a better case could be made for 13(b) disgorgement authority, there is more recent precedent than *Porter v. Warner Holding Co.,* which casts some doubt on that authority.") (citation omitted).

albeit less clear than, the elaborate enforcement scheme in the FTC Act.[72] The D.C. Circuit has also held that the implied equitable remedy of disgorgement is not available to address "forward-looking" injunctive provisions, such as those contained in the FTC Act.[73] Finally, even the FTC Chairman has acknowledged by implication that Section 13(b) does not authorize the recovery of monetary relief when he cited only to Section 19(b) to support his recent statement to Congress that the Commission "can only obtain monetary relief, including consumer redress and disgorgement of the ill-gotten gains."[74]

Read together, current case law, the express terms of Section 13(b) and 19, the characterizations of Sections 13(b) and 19(b) in other sections of the FTC Act[75], and the applicable and relevant legislative history demonstrate that Section 13(b) was intended to be limited to the plain meaning of its terms—providing the FTC with authority to seek, and the courts with authority to grant *temporary restraining orders, preliminary injunctions and, in appropriate cases, permanent injunctions.* In short, the purpose of Section 13(b) was to provide a mechanism to halt illegal conduct and maintain the status quo, thus allowing the FTC to bring administrative proceedings and, if appropriate, to seek the broader remedies that were made available under the limited circumstances specified in Section 19(b).

Having secured, for the time being, the Judiciary's blessing of its ability to obtain complete relief against FTC Act violators in court, outside of the cumbersome restrictions and limitations set forth in Section 19(b) and the administrative process,[76] the FTC

72. Meghrig v. KFC W., Inc., 516 U.S. 479, 487–88 (1996).

73. United States v. Phillip Morris USA, Inc., 396 F.3d 1190, 1198 (D.C. Cir. 2005).

74. *Proposed Consumer Financial Protection Agency: Implications for Consumers and the Federal Trade Commission: Hearing Before the Subcomm. on Commerce, Trade and Consumer Protection of the H. Comm. on Energy and Commerce* 3–4 (2009) (statement of the Fed. Trade Comm'n).

75. *See* § 16 (codified at 16 U.S.C. § 56) (describing §13(b) as providing for injunctive relief and § 19(b) as providing for "consumer redress").

76. Prior to 1980, virtually all FTC consumer protection enforcement actions were administrative proceedings conducted pursuant to § 5. Compare FTC Annual Report (1970) with FTC Annual Report (2009). By contrast, the most recent data shown on the FTC website reflects only nine pending FTC adjudicative proceedings from 2007 to 2009. Meanwhile, the FTC's annual report dated March 30, 2009 states that from March 2008 through February 2009, the FTC filed 64 actions in federal district courts. THE FTC IN 2009: THE ANNUAL REPORT OF THE FEDERAL TRADE COMMISSION (2009).

has apparently now turned its attention to unilaterally expanding its rulemaking authority.[77]

III. THE FTC'S RULEMAKING AUTHORITY

The FTC's authority to prescribe substantive rules defining the terms "unfair or deceptive acts or practices" emanates from Congress in two forms: (1) a specific delegation of rulemaking authority by Congress in statutes that direct the agency to promulgate rules in support of a specific statutory purpose,[78] and (2) pursuant to the rulemaking authority granted by the Magnuson–Moss Act in Section 18 of the FTC Act.[79]

Due to the restrictions imposed by Magnuson–Moss rulemaking, however, the vast majority of the FTC's substantive rules have been promulgated using "expedited" rulemaking procedures based on express congressional authorizations. Examples of specific statutory delegations include:

- The 2009 Omnibus Appropriations Act, which authorized the FTC to engage in Administrative Procedures Act (APA)[80] rulemaking proceedings relating to mortgage loans,[81]

- The Do-Not-Call Implementation Act of 2003, which allowed consumers to opt-out of receiving calls from telemarketers,[82]

- The Children's Online Privacy Protection Act, prohibiting online marketers from seeking or obtaining personal information from children,[83]

- The Fair and Accurate Credit Transactions Act of 2003, authorizing consumers to obtain free copies of their annual credit reports,[84]

77. *See infra* Part III.
78. *E.g.*, 15 U.S.C. § 6502(b)(1) (2006).
79. *Id.* § 57a(1)(B) (2006).
80. 5 U.S.C. § 553 (2006).
81. Pub. L. No. 111-8 § 626(a), 123 Stat. 524, 677 (2009).
82. 15 U.S.C. § 6153 (2006).
83. *Id.* § 6502(b)(1)(a).
84. *Id.* § 1681s(a)(1).

- The Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003, regulating the distribution of commercial electronic correspondence,[85] and

- The TCFAPA, which authorized the FTC to propound rules governing abusive telemarketing activities.[86]

The benefit of such statutory delegations of rulemaking authority, at least in the eyes of the FTC, is that the agency is not required to comply with the requirements of the Magnuson–Moss Act.[87] In each instance, Congress expressly authorized the FTC to utilize the simplified "notice-and-comment" provisions of the APA, substantially shortening the rulemaking process and eliminating many of the constraints that were imposed by Magnuson–Moss.[88] As Commissioner Thomas Rosch put it, "Magnuson–Moss rulemaking proceedings are very cumbersome, and frankly, the [Bureau of Consumer Protection] staff has hated them."[89] In a recent interview, David Vladeck, current Director of the Bureau of Consumer Protection, said, of the Magnuson–Moss procedures, "we are now hobbled with a byzantine, Rube Goldberg-like rulemaking system that is close to useless."[90]

Other than the specific statutes where Congress has expressly authorized the agency to use APA rulemaking procedures, the FTC acknowledges that "Section 202(a) of Magnuson–Moss provides that the Commission's Section 18 authority is its only authority to promulgate rules respecting unfair or deceptive acts or practices."[91] In fact, the staff "hates" the requirements of Section 18 to the extent that FTC Chairman Jon Leibowitz, in an effort to expand the Commission's rulemaking authority, recently appealed to Congress to allow the agency to utilize the

85. *Id.* § 7706(d).
86. *Id.* § 6102(a)(1).
87. *Id.* § 57(a)(1)(B).
88. *Id.* § 57(a)(1)(B).
89. J. Thomas Rosch, Comm'r, Fed. Trade Comm'n, Rip Van Winkle Awakens: Some Reflections on Remedies, Remarks at ABA Antitrust Section Spring Meeting 3 (Mar. 30, 2006), *available at* http://www.ftc.gov/speeches/rosch/060330roschfinal.pdf.
90. Villafranco, *supra* note 59.
91. FED. TRADE COMM'N, OPERATING MANUAL, § 7.2.3.1 (1989).

less "cumbersome" procedures of the APA to perform rulemaking in additional areas beyond those specifically delegated by Congress—such as the mortgage lending industy.[92] The Chairman's appeal illuminates why the FTC prefers the simplified APA rulemaking procedures over the more complex plenary procedures required when the staff seeks to regulate beyond those areas expressly designated by Congress.

The Magnuson–Moss rulemaking provisions require the FTC to:

- Publish a notice of proposed rulemaking in the Federal Register, including the text of and reasons for the proposed rule and invite the response of interested persons;[93]

- Submit notices of rulemaking to the Senate Committee on Commerce, Science, and Transportation and the House Committee on Energy and Commerce;[94]

- Make a determination before issuing any notices of proposed rulemaking if it has reason to believe that the unfair or deceptive acts or practices which are the subject of the proposed rule are "prevalent";[95]

- Provide an opportunity for an informal hearing subject to specific procedural requirements, including the ability for interested persons to present oral and documentary evidence and, if the FTC determines that there are disputed issues of material fact to be resolved,

92. In March 2009, Chairman Leibowitz stated: "The FTC also believes that it could do more to assist consumers if it could use APA [§ 553] notice and comment procedures to promulgate rules for those entities under the Commission's jurisdiction for unfair and deceptive acts and practices related to financial services other than mortgage loans." *Consumer Credit and Debt: The Role of the Federal Trade Commission in Protecting the Public: Hearing Before the Subcomm. on Commerce, Trade and Consumer Protection of the H. Comm. on Energy and Commerce* 22–23 (2009) (statement of the Fed. Trade Comm'n).

93. 15 U.S.C. § 57a(b)(1) (2006).

94. *Id.* § 57a(b)(2)(B).

95. *Id.* § 57a(b)(3). The Act defines an act or practice as "prevalent" where the FTC has (1) "issued cease and desist orders regarding such acts or practices," *id.* § 57a(b)(3)(A), or (2) "any other information available to the Commission [that] indicates a widespread pattern of unfair or deceptive acts or practices." *Id.* § 57a(b)(3)(B).

to present rebuttal evidence and conduct cross-examinations of witnesses;[96] and

- Promulgate a final rule based on the record and provide a statement of basis and purpose that addresses the prevalence of the acts or practices addressed by the rule, the manner and context in which the acts or practices are unfair or deceptive, and regarding the economic effect of the rule on small businesses and consumers.[97]

The Magnuson–Moss procedures also provide for judicial review of the agency's rules by the federal Courts of Appeals[98] and directs that the courts shall set aside any rule that "is not supported by substantial evidence in the rulemaking record"[99] or if the Commission's failure to allow cross-examination or submission of evidence "precluded disclosure of disputed material facts that were necessary for fair determination by the Commission."[100]

IV. THE FTC'S RULEMAKING AUTHORITY UNDER THE TELEMARKETING SALES RULE

On August 16, 1995, the FTC promulgated the Telemarketing Sales Rule pursuant to its authority under the Telemarketing and Consumer Fraud and Abuse Prevention Act (TCFAPA).[101] The FTC views the rule as applying to virtually all "telemarketing," which means "a[ny] plan, program, or campaign . . . to induce the purchase of goods or services or to solicit a charitable contribution" involving more than one interstate telephone call.[102]

In pertinent parts, the TSR requires telemarketers to obtain a consumer's express verifiable authorization and to provide certain material information, such as the total cost of the service,

96. *Id.* § 57a(c)(2).
97. *Id.* § 57a(d).
98. *Id.* § 57a(e)(1).
99. *Id.* § 57a(e)(3)(A).
100. *Id.* § 57a(e)(3)(B).
101. FTC Telemarketing Sales Rule, *supra* note 7, §§ 310.1–8.
102. FTC NPRM, *supra* note 8, at 41,989.

before the consumer pays for the goods or services.[103] The TSR prohibits telemarketers from misrepresenting—expressly or implicitly—specific categories of information about a telemarketing transaction that is likely to affect a consumer's decision to purchase the goods or services offered.[104] These categories include, among others: (1) the total costs of the services offered; (2) any material restriction, limitation, or condition to purchase, receive, or use the services offered; (3) any material aspect of the performance, efficacy, nature, or central characteristics of the goods or services offered to the consumer, and (4) any affiliations with—or endorsements or sponsorships by—any person, organization, or government entity.[105]

The TSR exempts certain types of calls from its coverage. These include unsolicited calls from consumers, calls placed by consumers in response to a catalog, calls made in response to direct mail advertising, and calls made in response to "general media advertising."[106] "General media advertising" includes television commercials, infomercials, and home shopping programs.[107] Accordingly, the FTC's jurisdiction, under the TSR, does not extend to inbound calls induced by television commercials, radio, and the Internet.[108]

As with other statutory delegations of rulemaking authority, Congress expressly directs the FTC to promulgate rules implementing the TCFAPA using the "notice-and-comment" rulemaking procedures of the APA.[109] The TCFAPA specifically instructs the FTC to "prescribe rules prohibiting deceptive telemarketing acts or practices and other abusive telemarketing acts or practices."[110] The statute further enumerates specific provisions to be included in the TSR, including banning deceptive charitable solicitations,[111] prohibiting coercive or abusive patterns of telephone calls,[112] placing restrictions on

103. 16 C.F.R. § 310.3(a).
104. *Id.*
105. *Id.*
106. *Id.* § 310.6(b)(6).
107. *Id.* § 310.6(b)(5).
108. *Id.*
109. 15 U.S.C. § 6102(b) (2006).
110. *Id.* § 6102(a)(1).
111. *Id.* § 6102(a)(2).
112. *Id.* § 6102(a)(3)(A).

hours when calls can be made,[113] requiring prompt and clear disclosures relating to goods and services sold by telemarketing,[114] and mandating disclosure of the purpose of charitable telemarketing solicitations.[115]

Although the TCFAPA specifically limited the FTC's rulemaking authority to "deceptive *telemarketing* acts or practices and other abusive *telemarketing* acts or practices,"[116] when the FTC adopted the TSR, consistent with strategies it has used previously, the agency knowingly included a minor but important expansion of its delegated authority in the new rules. Moving beyond regulations controlling the appropriate content and execution of telemarketers' communications with consumers, the FTC decided to regulate the nature of certain *fees* that could be charged by companies that engaged in telemarketing. The agency accomplished this objective by expanding upon the "abusive telemarketing acts or practices" identified by Congress in the TCFAPA.

The FTC acknowledged in its Final Notice implementing the TSR that the TCFAPA directed it to include three specific provisions prohibiting "abusive telemarketing practices" that related to consumer privacy.[117] However, the agency decided to supplement these practices with five additional practices that it deemed "abusive."[118] The first two additional practices were undeniably consistent with the statutory purpose of eliminating abusive "telemarketing" practices. The rules prohibited: (1)

113. *Id.* § 6102(a)(3)(B).

114. *Id.* § 6102(a)(3)(C).

115. *Id.* § 6102(a)(3)(D).

116. *Id.* § 6102(a)(1) (emphasis added).

117. FTC Telemarketing Sales Rule Final Amended Rule, 68 Fed. Reg. 4580, 4613 (Jan. 29, 2003) (codified at 16 C.F.R. 310 (2009)). Even the legislative history cited by the FTC in support of these regulations confirms that Congress's rulemaking authority was intended to reach nothing other than privacy issues. *See id.* at 4614 n.395. The Final Notice stated:

> With respect to the bill's reference to 'other abusive telemarketing activities' . . . the Committee intends that the Commission's rulemaking will include proscriptions on such inappropriate practices as threats or intimidation, obscene or profane language, refusal to identify the calling party, continuous or repeated ringing of the telephone, or engagement of the called party in conversation with an intent to annoy, harass, or oppress any person at the called number. The Committee also intends that the FTC will identify other such abusive practices that would be considered by the reasonable consumer to be abusive and thus violate such consumer's right to privacy.

Id. (citing H.R. REP. NO. 103-20, at 8 (1993)).

118. *Id.* at 4614.

"threatening or intimidating a consumer, or using profane or obscene language,"[119] and (2) "causing any telephone to ring, or engaging any person in telephone conversation, repeatedly or continuously with intent to annoy, abuse, or harass any person."[120]

However, the agency added other "advance fee" prohibitions that went far beyond "telemarketing practices" into the realm of regulating the underlying business models themselves.[121] These provisions included bans against "requesting or receiving payment for credit repair services prior to delivery and proof that such services have been rendered,"[122] "requesting or receiving payment for recovery services prior to delivery and proof that such services have been rendered,"[123] and "requesting or receiving payment for an advance fee loan when a seller or telemarketer has guaranteed or represented a high likelihood of success in obtaining or arranging a loan or other extension of credit."[124]

Recognizing that it had stretched the limits of its authority to the breaking point, the FTC attempted to justify these provisions by claiming that the TCFAPA granted the agency "broad authority to identify and prohibit additional abusive telemarketing practices beyond the [Congressionally] specified practices that implicate privacy concerns."[125] Remarkably, the agency relied upon a *Webster's Dictionary* definition of the word "abusive" for this conclusion.[126] Casting a sideways glance to the fact that it had departed from the boundaries of its TCFAPA authority and was now operating in Magnuson–Moss territory, the FTC concluded its detour with an attempt to bolster the end-result with an analysis of the advance fee practices using its "traditional unfairness analysis."[127] Finding that "[a]n important

119. *Id.* at 4613.
120. *Id.*
121. *Id.* at 4613–14.
122. *Id.* at 4613.
123. *Id.* at 4613–14.
124. *Id.* at 4614.
125. *Id.*
126. *Id.* at 4614 n.398.
127. *Id.* at 4614. The FTC's unfairness analysis was originally based on the Supreme Court's decision in *Federal Trade Commission v. Sperry & Hutchinson Co.*, 405 U.S. 433 (1972). In 1981, it was affirmed by the FTC in its Statement of Policy on the Scope of Consumer Unfairness Jurisdiction. Letter from Fed. Trade Comm'n to Sen. Wendell H. Ford & Rep. John C. Danforth (Dec. 17, 1980), *available at*

characteristic common to credit repair services, recovery services, and advance fee loan services is that in each case the offered service is fundamentally bogus,"[128] the agency reached the unsurprising conclusion that "these practices meet the statutory criteria for unfairness."[129] As such, the FTC determined that it was authorized to regulate the timing of fees charged by these services, regardless of whether the advance fees had anything to do with the functional act of "telemarketing."[130]

V. THE DEBT-RELIEF-SERVICES INDUSTRY

American consumers are currently enduring the most difficult financial crisis since the Great Depression.[131] As of January 2009, credit-card debt was reported to have soared to an all-time high of $960 billion.[132] As a result of this dramatic increase in consumer debt, Americans have increasingly turned to debt-relief services for assistance.[133] Two distinct types of debt-relief-service providers have developed as the primary models offering debt-relief services to consumers: non-profit credit counseling agencies (CCAs) and for-profit debt-settlement companies.[134]

A. *Credit Counseling Agencies*

CCAs are traditionally non-profit entities that operate as a liaison between a consumer and his creditor to negotiate a debt-

---

http://www.ftc.gov/bcp/policystmt/ad-unfair.htm [hereinafter FTC Unfairness Policy Statement]. Congress codified these principles in § 5(n) of the FTC Act. 15 U.S.C. § 45(n) (2006).

128. FTC Telemarketing Sales Rule Final Amended Rule, *supra* note 116, at 4614.

129. *Id.*

130. *Id.* The FTC stated, "[A]ccordingly, the remedy imposed by the [TSR] to correct them is to prohibit requesting or receiving payment for these services until after performance of the services is completed." *Id.*

131. Liam Dennig, *Obama Leaves Markets in a VIX*, WALL ST. J., Jan. 23, 2010, at B12.

132. Suki Kim, Op-Ed, *Notes from Another Credit Card Crisis*, N.Y. TIMES, May 18, 2009, at A23.

133. FTC NPRM, *supra* note 8, at 41,990.

134. *Id.* at 41,990, 41,993. A third variety of debt-relief service providers, known as "debt consolidation," assists indebted consumers by offering new loans that consolidate the consumer's existing debts into a single loan with the goal of reducing the consumer's interest rate and monthly payments. *Id.* at 41,997. This option is of limited value in the current economic environment where, although interest rates are at historic lows, credit is extremely tight and most consumers who are struggling to meet their monthly payments do not qualify for new loans. In addition, the NPRM states that "[a]ccording to industry sources consulted by Commission staff, there are believed to be fewer than 100 for-profit credit counseling firms operating in the United States." *Id.* at 42,013 n.272. The NPRM proposes to regulate all of these service providers along with the for-profit debt-settlement industry under the proposed TSR amendments. *Id.* at 41,999.

management plan (DMP).[135] The credit counseling model typically begins with an assessment of the consumer's financial situation.[136] Once this analysis is completed, the CCA initiates contact with the consumer's unsecured creditors.[137] By working in cooperation with the consumer's creditors, the CCA determines what, if any, repayment options are available to the consumer based upon her income and total debt.[138] At the end of the negotiations, the credit counselor calculates a new payment schedule, typically with consolidated monthly payments extending over a period of three to five years.[139] During the term of the renegotiated payment schedule, the CCA collects monthly payments from the consumer and distributes appropriate amounts to each creditor.[140] Accordingly, this form of debt settlement may appeal both to consumers, who receive more manageable terms, and to creditors, who are paid the outstanding balances.

In exchange for their services, nonprofit CCAs receive remuneration from both the consumers and the creditors.[141] According to the National Foundation for Credit Counseling (NFCC), on average, consumers pay an upfront fee of $20 to enroll in a DMP and continue to pay a monthly $12 service fee.[142] The consumer's creditors also make a monthly "fair share" contribution to the CCA.[143] The fair share contribution can amount to as much as 15% of the amount received as a result of the DMP.[144]

CCAs have been criticized on a number of grounds. First, the CCA model was originally established as a non-profit adjunct of the credit card industry, assisting creditors to perpetuate and extend their payment flows beyond the point when consumers

135. *Id.* at 41,990.
136. *Id.*
137. *Id.*
138. *Id.* at 41,990–91.
139. *Id.* at 41,990.
140. *Id.* at 41,990–91.
141. *Id.* at 41,991.
142. *Id.* (citing DEANNE LOONIN & TRAVIS PLUNKETT, CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR. INC., CREDIT COUNSELING IN CRISIS: THE IMPACT ON CONSUMERS OF FUNDING CUTS, HIGHER FEES AND AGGRESSIVE NEW MARKET ENTRANTS 13–14 (2003)).
143. FTC NPRM, *supra* note 8, at 41,991.
144. *Id.* (citing LOONIN & PLUNKETT, *supra* note 141, at 10–12).

would naturally default on their loans.[145] Although this relationship has been severed to some extent in recent years, and creditors have steadily reduced the amount of their fair share contributions, CCAs are still viewed as agents of the credit card companies working to ensure that consumers continue to make monthly payments for as long as possible.[146] Second, the CCA model rarely involves a concession by the creditor that reduces the consumer's principal debt.[147] Generally, CCAs only obtain creditor concessions that reduce interest rates on existing debts, and can sometimes obtain a reduction in certain penalties or other fees charged by the credit card companies.[148] Depending upon their income and other financial resources, most indebted consumers can not qualify for DMPs,[149] which require the ability to make ongoing payments over three to five years.[150] Finally, studies have determined that DMP plans suffer from low success rates, with as few as one in five of the consumers that qualify and begin a DMP actually completing the program.[151] These less-than-stellar statistics have attracted both regulatory concern[152] and competition from the for-profit debt-relief industry.[153]

B. *Debt-Settlement Agencies*

In the late 1990s, the for-profit debt-settlement model developed as an alternative to CCAs.[154] As a result of the historic levels of consumer debt and the concomitant increase in demand for debt-relief services following the economic downturn that began in about 2000, for-profit debt-settlement

145. *See id.* ("Beginning in the mid-1960s, creditor banks initiated this model, providing funding for CCAs with the intent of reducing personal bankruptcy filings.").

146. The history and relationship between credit counseling and the banking industry is discussed by Harvey Warren in his book describing his experiences as president of the National Consumer Council, a non-profit organization that offered information about debt settlement to consumers until it was shut down by the FTC and the California Department of Corporations in May 2004. HARVEY Z. WARREN, FOREVER IN YOUR DEBT ch. 6 (2007). *See also, e.g.,* TASC Position Paper, (2006) *available at* http://www.ftc.gov/os/comments/debtsettlementworkshop/536796-00013.pdf.

147. FTC NPRM, *supra* note 8, at 41,990.

148. *Id.*

149. *Id.* at 41,993.

150. *Id.* at 41,990–91.

151. *See, e.g.*, *Pushed off the Financial Cliff*, CONSUMER REPORTS (Jul. 2001). In 2001, the National Foundation for Credit Counseling reported completion rates of 21%.

152. FTC NPRM, *supra* note 8, at 41,990.

153. *Id.* at 41,993.

154. *Id.*

companies now represent a substantial segment of the debt-relief-services industry.[155] The fact that an increasing number of consumers lack sufficient income to qualify for traditional DMPs has also led to the proliferation of for-profit debt-settlement companies to satisfy the growing need for debt relief. As a result, the industry has grown and matured significantly since its origins.

As indicated in the NPRM, for-profit debt-settlement companies are distinct from traditional CCAs in three principal respects. First, for-profits generally advertise their services to consumers through major mediums such as radio, television, and Internet.[156] Interested consumers generally initiate communications with the debt-settlement provider voluntarily by calling the advertised number.[157]

Second, for-profit debt-settlement companies offer to reduce the consumer's debt to a fraction of the principal.[158] Industry surveys indicate that debt-settlement companies often negotiate with debt collectors regarding accounts that are, due to their delinquency status, listed in the creditor's portfolio as losses.[159] Thus, creditors often agree to settle the debt for less than the full principal value in order to minimize losses.[160]

And third, debt-settlement companies offer to alleviate the attendant stresses of debt collection.[161] According to the FTC, many consumers drawn to debt-settlement companies are already behind on their debt payments and thus are subject to annoying debt-collection calls.[162] The debt-settlement companies generally instruct their clients to assign them powers of attorney, and then serve creditors with cease-communication notices.[163] As a corollary, the debt-settlement providers sometimes instruct customers to execute a change of address, substituting the debt-settlement company's address for the consumer's address and redirecting billing statements and collections notices so that the consumer no longer receives

155. *Id.*
156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.*
161. *Id.*
162. *Id.*
163. *Id.* at 41,994.

them.[164] The FTC contends that in this manner, for-profit providers offer consumers the hope of alleviating the stress of debt-collection calls by attempting to interpose themselves between the consumers and the debt collectors.[165]

Debt-settlement companies have generally adopted three major fee models.[166] The "front-end fee model" requires that customers pay a portion of the company's fee within the first three or four months of enrollment and the balance over the ensuing 12 months or less.[167] A second common fee structure, the "flat fee model," provides that the consumer will pay the entire fee over approximately the first half of the total enrollment period.[168] Finally, the "back-end model" requires the consumer to make a relatively small initial payment, nominal monthly payments for the duration of the plan, and then, when and if a settlement is achieved, an amount based on the total amount saved.[169]

VI. FTC'S ASSERTED BASIS FOR HEIGHTENED ENFORCEMENT MEASURES

Over the past decade, the FTC has shifted greater attention to entities operating in the debt-relief-services industry. In what the FTC maintains is a response to growing deceptive and unfair practices by debt-relief-services providers,[170] the Commission has undertaken six civil enforcement actions against CCAs[171] and seven actions against for-profit debt-settlement companies.[172]

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.* at 41,991.

171. Fed. Trade Comm'n v. Express Consolidation, No. 06-cv-61851-WJZ (S.D. Fla. 2006); United States v. Credit Found. of Am., No. CV 06-3654 ABC(VBKx) (C.D. Cal. 2006); Fed. Trade Comm'n v. Integrated Credit Solutions, No. 06-806-SCB-TGW (M.D. Fla. 2006); Fed. Trade Comm'n v. Nat'l Consumer Council, No. SACV04-0474 CJC(JWJX) (C.D. Cal. 2004); Fed. Trade Comm'n v. Debt Mgmt. Found. Servs., No. 04-1674-T-17-MSS (M.D. Fla. 2004); Fed. Trade Comm'n v. AmeriDebt, Inc., No. PJM 03-3317 (D. Md. 2003); FTC NPRM, *supra* note 8, at 41,991–92.

172. Fed. Trade Comm'n v. Debt-Set, Inc., No. 1:07-cv-00558-RPM (D. Colo. 2007); Fed. Trade Comm'n v. Edge Solutions, No. CV-07-4087 (E.D.N.Y. 2007); Fed. Trade Comm'n v. Connelly, No. SA CV 06-701 DOC (RNBx) (C.D. Cal. 2006); Fed. Trade Comm'n v. Better Budget Fin. Servs., Inc., No. 04-12326 (WG4) (D. Mass. 2004); Fed. Trade Comm'n v. Innovative Sys. Tech., Inc., No. CV04-0728 GAF JTLx (C.D. Cal. 2004); Fed. Trade Comm'n v. Nat'l Consumer Council, No. SACV04-0474 CJC(JWJX) (C.D. Cal.

The actions brought against CCAs have generally been based upon fraud-related claims and, in some instances, for violations of the TSR.[173] Against for-profit debt-settlement companies like: "the FTC's actions against deceptive credit counselors, . . . these suits commonly allege the misrepresentation of fees, or the failure to fully disclose them—including the significant up-front fees that are often charged."[174] Additionally, the Commission has alleged that "these defendants falsely promised high success rates, promised unattained results (*e.g.*, settlements for a certain percentage of the total original debt), and misrepresented their refund policies."[175] Further, "the Commission['s] complaints charged that the defendants in these matters failed to warn consumers of the negative consequences of debt settlement, including the accumulation of late fees and other charges, the effect on consumers' credit ratings, and the fact that debt collectors would continue to contact consumers."[176]

Consistent with the FTC's policy of abandoning the administrative enforcement process in favor of bringing civil actions based on Sections 13(b) and 19, the NPRM does not reflect that the agency has issued any cease and desist orders against any CCAs or debt-settlement companies.[177]

VII. SUMMARY OF THE FTC'S PROPOSED AMENDMENTS TO TSR

In its effort to police the debt-services industry, the FTC has apparently decided that additional legal restrictions are needed. The agency has proposed certain amendments to the TSR specifically intended to increase the agency's ability to regulate debt-relief providers.[178] Because the FTC's jurisdiction does not extend to non-profit entities,[179] however, the proposed TSR

2004); Fed. Trade Comm'n v. Jubilee Fin. Servs., Inc., No. 02-6468 ABC (Ex) (C.D. Cal. 2002); FTC NPRM, *supra* note 8, at 41,992.

173. *See* FTC NPRM, *supra* note 8, at 41,992 (stating that the enforcement actions stemmed from deceptive statements, misrepresentation, and violations of the TSR).

174. *Id.* at 41,996.

175. *Id.*

176. *Id.*

177. As discussed *supra* Part III, a record of issuing prior cease and desist orders is one means of meeting the "prevalence" requirement for the agency to conduct rulemaking under § 18. 45 U.S.C. § 57a(b)(3)(A) (2006).

178. FTC NPRM, *supra* note 8, at 42,017–24.

179. The FTC discusses the determination that non-profit entities are not subject to its jurisdiction in the NPRM:

> Section 5(a)(2) of the FTC Act states: "The Commission is hereby empowered and directed to prevent persons, partnerships, or corporations . . . from using

amendments would apply only to for-profit debt-relief entities companies.[180]

The proposed amendments address a wide spectrum of activities engaged in by debt-relief providers. Proposed Section 310.2(m), for example, provides a broad definition of "debt-relief service" to include DMPs, debt-settlement services, and debt-negotiation services.[181] The definition expressly excludes services provided that relate to secured debt and mortgage loans.[182]

The proposed amendments would significantly expand the TSR's coverage of debt-relief providers by eliminating the Rule's current exemption of most *inbound calls* from consumers in response to advertisements[183] and qualifying direct mail solicitations.[184] TSR Section 310.6 presently exempts calls "initiated by a customer . . . in response to an advertisement through any medium"[185] and exempts calls "initiated by a

> unfair or deceptive acts or practices in or affecting commerce." Section 4 of the Act defines "corporation" to include: "any company, trust, so-called Massachusetts trust, or association, incorporated or unincorporated, *which is organized to carry on business for its own profit or that of its members* . . . ."

Id. at 11,998 (citations omitted)

180. FED. TRADE COMM'N, ADDITIONAL REPORT TO CONGRESS PURSUANT TO THE DO NOT CALL REGISTRY FEE EXTENSION ACT OF 2007, at 10 (2009).

181. Proposed § 310.2(m) defines the term "debt relief service" to mean:

> any service represented, directly or by implication, to renegotiate, settle, or in any way alter the terms of payment or other terms of the debt between a consumer and one or more unsecured creditors or debt collectors, including, but not limited to, a reduction in the balance, interest rate, or fees owed by a consumer to an unsecured creditor or debt collector.

FTC NPRM, *supra* note 8, at 42,017.

182. *Id.*

183. The FTC's TSR compliance guide states that "[t]he Rule generally does not apply to consumer calls made in response to . . . television commercials; infomercials; home shopping programs; print advertisements in magazines, newspapers, the Yellow Pages, or similar general directories; radio ads; banner ads on the Internet; and other forms of mass media advertising and solicitation." Federal Trade Commission, Facts for Business, Complying with the Telemarketing Sales Law, http://www.ftc.gov/bcp/edu/pubs/business/marketing/bus27.shtm.

184. "Generally, consumer calls in response to a direct mail solicitation that clearly, conspicuously, and truthfully makes the disclosures required by the Rule are exempt from the Rule." *Id.* "Direct mail advertising includes, but is not limited to, postcards, flyers, door hangers, brochures, 'certificates,' letters, email, facsimile transmissions, or similar methods of delivery sent to someone urging a call to a specified telephone number regarding an offer of some sort." *Id.*

185. 16 C.F.R. § 310.6 (2009). The exemption does not apply to consumer-initiated calls in response to advertisements for investment or business opportunities not covered by the Franchise Rule, credit card protection, credit repair, recovery services, advance fee loans, or instances of "upselling" additional products or services that were not included in the advertisement. *Id.*

customer . . . in response to a direct mail solicitation," including facsimiles and e-mail solicitations that meet certain requirements.[186] The proposed amendments would require for-profit providers that advertise on radio, television, the Internet or by mail, e-mail, or facsimile, who were previously exempt from the TSR's disclosure requirements, to comply with the Rule on all calls, whether outbound or incoming.[187] "As a result, virtually all debt-relief telemarketing transactions would be subject to the TSR if the proposed modifications to the Rule are adopted."[188]

Apart from expanding the Rule's coverage to most inbound calls, the proposed amendments would require debt-relief providers to make six additional material disclosures that are not required of any other telemarketers. These new disclosures include:

- The amount of time required to achieve the purported results of a DMP or debt-settlement program;[189]

- The amount of money or percentage of each of the consumer's outstanding debts that would have to be accumulated before the debt-relief provider will make settlement offers to each of the customer's creditors;[190]

- A statement that "not all creditors or debt collectors will accept a reduction in the balance, interest rate, or fees a customer owes such creditor or debt collector";[191]

- Notification that, "pending completion of the represented debt-relief services, the customer's creditors or debt collectors may pursue collection efforts, including initiation of lawsuits";[192]

186. *Id.*
187. FTC NPRM, *supra* note 8, at 41,999.
188. *Id.*
189. *Id.* at 42,019.
190. *Id.*
191. *Id.*
192. *Id.*

- That the use of the debt-relief service will likely adversely affect the consumer's creditworthiness, may result in consumers being sued by their creditors, and may increase the amount owed to creditors as a result of the accrual of additional fees and interest;[193] and

- A statement that any "savings a customer realizes from use of a debt-relief service may be taxable income."[194]

Current TSR Section 310.3(a)(4) prohibits "[m]aking a false or misleading statement to induce any person to pay for goods or services,"[195] and Section 310.3(a)(2) prohibits telemarketers from making specified misrepresentations of material information.[196] Yet, despite these existing provisions, which broadly prohibit telemarketers from misrepresenting their products or services, the FTC has decided it should amend the TSR to add additional provisions banning debt-relief providers from making specific misrepresentations regarding their services.

Proposed Section 310.3(a)(2)(x) would specifically prohibit telemarketers of debt services from misrepresenting any material aspect of debt-relief services, including (but not limited to) a laundry list of issues.[197] The proposed amendment would expressly ban, among other things, misstatements regarding the percentage or number of customers that attain the represented results and the amount of time necessary to achieve the represented results.[198]

193. *Id.*

194. *Id.*

195. 16 C.F.R. § 310.3(a)(4) (2009).

196. *Id.* § 310.3(a)(2).

197. FTC NPRM, *supra* note 8, at 42,019.

198. Proposed § 310.3(a)(2)(x) would specifically prohibit misrepresentations regarding, among other issues, the amount of money or the percentage of the debt amount that a customer may save by using such service; the amount of time necessary to achieve the represented results; the amount of money or the percentage of each outstanding debt that the customer must accumulate before the provider of the debt-relief service will initiate attempts with the customer's creditors' debt collectors to negotiate, settle, or modify the terms of customer's debt; the effect of the service on a customer's creditworthiness; the effect of the service on collection efforts of the consumer's creditors or debt collectors; the percentage or number of customers who attain the represented results; and whether a service is offered or provided by a non-profit entity. *Id.* at 42,003.

Finally, and most significantly to the debt-settlement industry, proposed Section 310.4(a)(5) would impose an "advance fee" ban on debt-relief-service providers, similar to the ban imposed in the TSR on credit-repair services, recovery services, and advance fee loan services.[199] The proposed amendment, which would be added to Section 310.4 prohibits:

> [r]equesting or receiving payment of any fee or consideration from a person for any debt relief service until the seller has provided the customer with documentation in the form of a settlement agreement, debt management plan, or other such valid contractual agreement, that the particular debt has, in fact, been renegotiated, settled, reduced, or otherwise altered.[200]

The NPRM expressly refers to the "analytical framework" developed in the original TSR to support the advance fee ban on credit-repair services, recovery services, and advance fee loan services, and claims that the same considerations for prohibiting the imposition of advance fees by those industries also apply to advance fees charged by debt-relief providers.[201] Reprising its analysis in the original TSR,[202] the FTC asserts that although "[t]he Telemarketing Act directs the Commission to include in the TSR provisions to address three specific practices denominated by Congress as 'abusive,' . . . . the Act 'does not limit the Commission's authority to address abusive practices beyond these three practices legislatively determined to be abusive.'"[203] Once again the agency relies on the definition of the word "abusive" in *Webster's Dictionary* as authority for

199. *See* discussion *supra* Part III.

200. FTC NPRM, *supra* note 8, at 42,009.

201. *Id.* at 42,005.

202. FTC Telemarketing Sales Rule Notice of Proposed Rulemaking, 67 Fed. Reg. 4492, 4510 (Jan. 30, 2002) (codified at 16 C.F.R. § 310 (2009)).

203. FTC NPRM, *supra* note 8, at 42,005. Remarkably, the authority for the proposition that "the Act does not limit the Commission's authority to address abusive practices beyond these three practices legislatively determined to be abusive" is nothing more than the agency's own Proposed Rule issued in 2002. *Id.* at 42,005 n.202. In other words, the FTC's supporting authority for this proposition consists of no more than its own prior analysis, which was founded on the definition of the word "abusive" in the 1949 edition of Webster's International Dictionary. FTC Telemarketing Sales Rule Notice of Proposed Rulemaking, *supra* note 201, at 4,511 n.176.

exceeding the scope of Congress's express statutory authorization.[204]

The FTC reprised its application of the Section 5(n) "unfairness" standards,[205] used to justify the original TSR regulation of advance fees, to the proposed debt-relief advance fee ban, determining once again that such a prohibition did not exceed its rulemaking authority.[206] Based upon "the information available to the Commission,"[207] the FTC found that the first unfairness element of substantial injury to consumers had been shown by its determinations that, according to the FTC, debt-relief services (1) provide a "low likelihood of success,"[208] and (2) impose the "significant burden on consumers of front-loaded fees."[209] Ignoring the industry's claim that 35–60% of debt-settlement consumers complete their programs,[210] the FTC based its conclusion that debt relief provides a low likelihood of success primarily on statistics gathered from three FTC civil

204. FTC NPRM, *supra* note 8, at 42,005 n.204. The agency acknowledges once again that the TSA's statutory grant of authority to regulate "abusive practices" was clearly grounded in addressing privacy concerns:

> In determining which conduct should be characterized by the TSR as abusive, the Commission noted that each of the statutorily-denominated abusive practices implicate consumers' privacy. Nevertheless, the plain meaning of the term 'abusive' suggests that no such inherent limitation in the meaning of the term constrains the Commission in crafting the Rule.

FTC NPRM, *supra* note 8, at 42,005.

205. Section 5(n) provides:

> The Commission shall have no authority under this section or section 57a of this title to declare unlawful an act or practice on the grounds that such act or practice is unfair unless the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. In determining whether an act or practice is unfair, the Commission may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination.

15 U.S.C. § 45(n) (2006).

206. FTC NPRM, *supra* note 8, at 42,005.

207. *Id.* at 42,006. Although the NPRM mentions "complaint data, [the FTC's] law enforcement experience, as well as state enforcement efforts, the [debt-relief industry] Workshop [conducted by the agency in September 2008], and additional independent research conducted by Commission staff," the "state enforcement efforts" appear to be limited to the New York Attorney General's action mentioned in footnote 215 and there is no further discussion of the "additional independent research conducted by Commission staff." *Id.*

208. *Id.*

209. *Id.* at 42,007.

210. THE ASS'N OF SETTLEMENT COS., STUDY ON THE DEBT SETTLEMENT INDUSTRY 1 (2007).

enforcement actions[211] and on the unproven allegations contained in a press release issued by the New York Attorney General's office.[212] The agency found a "significant burden" existed on consumers from the fact that the "front-end" fee model is the most prevalent in the industry and that "substantial harm accrues when debt-relief providers charge fees and then fail to provide the represented services."[213] What is missing from the FTC's analysis, however, is any data supporting the prevalence of debt-relief providers taking fees without delivering services. Although the agency found it "telling that nearly all states have now adopted laws that regulate the provision of some or all debt-relief services,"[214] the FTC mentions only one state, North Carolina, which prohibits debt-relief providers from charging advance fees,[215] which seems more telling.

Disturbingly, in support of its claim that consumers experienced low success rates, the FTC once again trotted out one of its favorite statistics about the debt-relief industry, claiming that its civil enforcement action brought against the National Consumer Council (NCC) and other defendants in 2004, "show[ed] that only 1.4% of the consumers that entered defendant's debt-settlement program obtained the promised results."[216] In truth, the NCC case was a bungled prosecution that put a responsible and effective debt-relief program out of business and left nearly 25,000 financially troubled consumers without access to their savings and without the company's assistance.[217] Remarkably, the FTC seized upon a statistic in the court-appointed receiver's report that reflected that very few consumers had completed the debt-relief program.[218] What the FTC repeatedly neglects to disclose is that the reason so few

211. FTC NPRM, *supra* note 8, at 41,995 n.102 (citing Fed. Trade Comm'n v. Connelly, No. SA CV 06-701 DOC (RNBx) (C.D. Cal. 2006); Fed. Trade Comm'n v. Debt Solutions, Inc., No. 06-0298 (W.D. Wash. 2006); Fed. Trade Comm'n v. Nat'l Consumer Council, Inc., No. SACV04-0474 CJC(JWJX) (C.D. Cal. 2004)).

212. *Id.*

213. *Id.* at 42,007.

214. *Id.*

215. *Id.* at 41,996 n.121; *see* N.C. GEN. STAT. § 14-424 (making any person engaged in debt adjusting guilty of a Class 2 misdemeanor). In North Carolina, debt adjusting includes charging advance fees. *Id.* § 14-423(2).

216. FTC NPRM, *supra* note 8, at 41,995 n.102.

217. WARREN, *supra* note 145, ch. 1.

218. Press Release, Fed. Trade Comm'n, Debt Services Operations Settle FTC Charges (Mar. 30, 2005), *available at* http://www.ftc.gov/opa/2005/03/creditcouncel.shtm.

consumers graduated was that the FTC prematurely *shut down* the NCC program after it operated for only thirty-nine months, with all but a miniscule number of consumers spending less than projected thirty-six months required to complete the program.[219] More than half of those who had enrolled in the program were still enrolled and relying on the program to help them settle their debts.[220] The FTC obtained a court order shuttering the company without any notice based upon comparisons to "operational problems, accounting irregularities, and stolen consumer funds" encountered by regulators in previous actions against other debt-settlement companies;[221] however, these comparisons proved to be inapplicable in the NCC case, where the receiver determined that all of the consumer funds were present and properly accounted for.[222] At the time it was terminated by the FTC's action, the program was exceeding its marketing representations by generating average settlements at the rate of 57.3% of their principal debt balances (excluding fees).[223] In consistently quoting the NCC 1.4% completion percentage, the FTC has purposely kept the NCC receiver's findings, which show that debt settlement can provide a substantial benefit for consumers that have the opportunity to complete the program out of the debate.[224] A second unfairness requirement considered by the FTC was whether there are potential countervailing benefits to consumers or competition.[225] The FTC briefly considered the industry's claims that eliminating advance fees would be an unsustainable business

219. Report of Temporary Receiver's Activities, May 3, 2004–May 14, 2004, First Report to the Court, FTC v. National Consumer Council, et. al., SACV 04-0474 CJC (JWJx).

220. *Id.*

221. WARREN, *supra* note 145, ch. 1.

222. Report of Temporary Receiver's Activities, *supra* note 218.

223. *Id.* at 7-8. The receiver's report reflects that "[t]he debt reduction process was promoted to potential and existing consumers as the opportunity to reduce consumer debt by 25% to 50% and then become debt free." Based on the 57.3% settlement rate, the program was saving consumers an average of 42.7%, exclusive of fees. Even after the program fees are deducted, the program generated savings of approximately 20% from their principal balance *as of the start* for consumers who completed the program.

224. When the FTC shut down the NCC and its supporting companies, consumers enrolled in an NCC certified debt settlement program had, according to the court-appointed receiver, settled 40,572 cards totaling $196,451,977 of debt for $80,419,080 at an average settlement percentage of 41.57%. *Id.* When total average savings percentage was still over 33%. *Id.* These numbers did not and do not support the notion that consumers derive no benefit from a properly run debt settlement program.

225. FTC NPRM, *supra* note 8, at 42,008.

model and would create a barrier to entry; that the stream of clients' advance fees is required to pay the marketing and labor costs that occur before and while settlement negotiations occur; and that if debt-settlement companies are not paid until after they complete settlement negotiations, they will be forced into the role of becoming their clients' creditors.[226] However, the agency found that "insufficient empirical data have been presented to substantiate that these purported benefits outweigh what appears to be substantial harm to consumers."[227]

Significantly, the FTC acknowledged that

> at least conceivably, such [an advance fee] prohibition could increase the costs incurred by any legitimate providers of debt relief services, make it impossible for some firms to continue to exist, and reduce the ability of new firms to enter the market. . . . If existing providers' costs are increased, they could be forced to increase the prices they charge consumers for their services in order to remain solvent.[228]

However, the agency's underlying doubts as to whether debt-relief provides any real services or benefits to consumers apparently negated this concern:

> [T]he record lacks any empirical data on whether debt relief companies actually provide the debt relief as represented to consumers. In fact, the federal and state law enforcement record demonstrates that few, if any consumers who pay upfront fees, receive any benefits from the advance fee practices. Thus, any increase in costs resulting from the advance fee ban would be unlikely to outweigh the consumer injury resulting from the current fee practice.[229]

The third unfairness factor considered by the FTC was whether the injury caused by advance fees is one that consumers can reasonably avoid.[230] The reasonable avoidance standard is designed to ferret out those instances where consumers can

> make their own private purchasing decisions without regulatory intervention [and] survey the available alternatives, choose those that are the most desirable, and avoid those that are inadequate or unsatisfactory. However, it has long been

226. *Id.*
227. *Id.*
228. *Id.*
229. *Id.*
230. *Id.* at 42,008 n.235.

> recognized that certain types of sales techniques may prevent consumers from effectively making their own decisions, and that corrective action may then become necessary.[231]

In those circumstances, the FTC has taken the position that rulemaking, enforcement activity, or both, is appropriate.

The FTC based its NPRM determination that consumers cannot reasonably avoid the injury caused by advance fees on the unsupported and circular premises that "the offered services are illusory"[232] and "the promised services are almost never provided."[233] Yet the agency fails to identify any substantial evidence supporting these statements.[234] Without any showing that the debt-relief industry is "fundamentally bogus," as it purported to show with respect to credit-repair services, recovery services, and advance fee loan services when it enacted the advance fee prohibition in the original TSR,[235] the FTC's determination that injury from debt-relief companies cannot be reasonably avoided by consumers is based, at best, on assumption and speculation.

231. FTC Unfairness Policy Statement, *supra* note 126.

232. FTC NPRM, *supra* note 8, at 42,008.

233. *Id.*

234. The FTC's support for its claim that services, "in most cases, are never provided to the vast majority of consumers," is limited to information that was purportedly gathered from FTC enforcement actions. *Id.* at 42,006. As noted, however, in the only example identified by the FTC, which involved the NCC, the FTC's conclusions were unfounded.

235. FTC Telemarketing Sales Rule Final Amended Rule, *supra* note 116, at 4,614.

VIII. THE FTC'S AUTHORITY TO AMEND THE TELEMARKETING SALES RULE TO ADOPT REGULATIONS TARGETED AT THE DEBT-RELIEF INDUSTRY

"Plainly, if we were 'to presume a delegation of power' from the absence of 'an express withholding of such power, agencies would enjoy virtually limitless hegemony . . . .'"[236]

In 2009, the FTC apparently determined that the debt-relief industry was harming American consumers and that its Section 5 authority to prohibit and enforce "unfair and deceptive acts or practices"[237] was insufficient to effectively regulate the industry. In response, the FTC moved to enhance its available tools by utilizing the rulemaking process to curtail the debt-relief industry. Because the FTC staff "hated" the formal rulemaking process provided by Congress in the Magnuson–Moss Act, viewing it as "cumbersome,"[238] the FTC is seeking to shortcut the process by unilaterally and improperly expanding the scope of the TCFAPA to justify issuance of rules governing the debt-relief industry.

The FTC's rulemaking authority under the TCFAPA is limited to remedying abusive telemarketing sales practices.[239] To the extent the FTC's proposed rules legitimately address abusive telemarketing activities, the agency's use of its TCFAPA rulemaking authority is probably appropriate to the extent particular debt-settlement marketing falls within the existing reach of the TSR. Examples of such provisions included among the proposed amendments are the disclosure requirements set forth in Proposed Section 310.3(a)(1)(viii)[240] and the prohibited representations set out in Proposed Section 310.3(a)(2)(x).[241] These proposed amendments, although targeted solely at the debt-relief industry, implement new regulations designed to remedy purportedly abusive telemarketing sales practices, which is clearly within the scope of the authority granted to the FTC by Congress.

236. Am. Bar Ass'n v. Fed. Trade Comm'n, 430 F.3d 457, 468 (D.C. Cir. 2005) (quoting Ry. Labor Exec. Ass'n v. Nat'l Mediation Bd., 29 F.3d 655, 671 (D.C. Cir. 1994) (en banc)).

237. 15 U.S.C. § 45(a) (2006).

238. Rosch, *supra* note 88, at 3.

239. *See supra* Part III.

240. FTC NPRM, *supra* note 8, at 42,019.

241. *Id.*

The FTC's proposed TSR amendments are invalid to the extent they exceed that authority. In *Chevron, U.S.A., Inc. v. Natural Resources Defense Council,*[242] the Supreme Court discussed the standard for reviewing an agency's construction of a statute it administers: "First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[243] In evaluating Congress' intent, the courts utilize "traditional tools of statutory construction," including the terms, legislative history, and purposes of the statute.[244] If the court "ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect."[245]

Both the express language of the TCFAPA and its legislative history make clear that the purpose of the Act was to remedy abusive *telemarketing sales practices* that were causing substantial harm to consumers' financial and privacy interests. Congress entrusted the FTC to utilize its "valuable experience in combating such activities"[246] to "prescribe rules prohibiting deceptive telemarketing acts or practices and other abusive telemarketing acts or practices."[247] To carry out this authority, Congress directed the FTC to establish a "definition of deceptive telemarketing acts or practices which shall include fraudulent charitable solicitations, and which may include acts or practices of entities or individuals that assist or facilitate deceptive telemarketing, including credit card laundering."[248] The legislative history of the TCFAPA reflects that Congress never intended "that telemarketing practices be considered per se 'abusive.' The [House] Committee [on Energy and Commerce] is not interested in further regulating the legitimate telemarketing industry through this legislation."[249]

In its discussion of the kinds of "other abusive practice" that should be prohibited in the FTC's regulations, the House

242. 467 U.S. 837 (1984).
243. *Id.* at 842–43.
244. *Id.* at 843 n.9.
245. *Id.*
246. H.R. REP. NO. 103-20, at 8 (1994).
247. 15 U.S.C. § 6102(a)(1) (2006).
248. *Id.* § 6102(a)(2).
249. H.R. REP. NO. 103-20, at 4.

Committee's report provided a laundry list of "inappropriate practices," similar to the specific provisions that were expressly included in the Act.[250] Beyond those delineated practices, the Committee stated that it "also intends that the FTC will identify such other abusive practices that would be considered by the reasonable consumer to be abusive *and thus violate such consumer's right to privacy*."[251] As an example of such "other abusive practices," the Committee described a scenario where an aggressive telemarketer randomly calls consumers late at night in an effort to reach people who stay up late at night, disregarding the annoyance caused to the vast majority of consumers that would be awakened by such calls.[252] Significantly, the Committee provided no examples of "other abusive conduct" that supported, in any respect, the adoption of regulations of how or when telemarketers may charge consumers for their products or services.

In *Chevron*, the Supreme Court also set out the second part of the analysis to be applied in the event that a reviewing court determines that Congress's intentions are unclear:

> If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.[253]

In such instances, the court determines "whether the agency's interpretation is a permissible construction of the statute."[254]

250.

> With respect to the bill's reference to 'other abusive practices,' . . . the Committee intends that the Commission's rulemaking will include proscriptions on such inappropriate practices as threats or intimidation, obscene or profane language, refusal to identify the calling party, continuous or repeated ringing of the telephone or engagement of the called party in conversation with an intent to annoy, harass, or oppress any person at the called number.

Id. at 8.

251. *Id.* (emphasis added).

252. *Id.*

253. Chevron, U.S.A., Inc. v. Natural Res. Def. Council, 467 U.S. 837, 843 (1984).

254. Mainstream Mktg. Sys., Inc. v. Fed. Trade Comm'n, 358 F.3d 1228, 1250 n.16 (10th Cir. 2004).

In this case, the FTC adopted the original TSR, including the provisions prohibiting credit-repair services, recovery services, and advance fee loan services from charging advance fees, despite evidence that these provisions were inconsistent with the agency's *own* interpretation of the statutory authority that had been granted by Congress under the TCFAPA. This same analysis indicates that the FTC relied on its Section 5 rulemaking authority, rather than the authority granted by Congress in the TCFAPA, to implement the advance fee provisions in the original TSR. Because the FTC failed to comply with the Section 5 rulemaking requirements imposed by Magnuson–Moss when it enacted the advance fee provisions in the original TSR, however, those provisions, as well as the currently proposed amended advance fee provisions, are invalid.

In the Notice of Proposed Rulemaking for the original TSR, the FTC acknowledged several times that the "other abusive telemarketing practices" that Congress authorized the agency to address in Section 6102(a)(2) of the TCFAPA are linked to telemarketing conduct that affects consumers' privacy rights. First, the agency affirmed that its proposed TSR prohibitions against threatening or intimidating a consumer, using profane or obscene language, or causing a consumer's phone to ring repeatedly or continuously to annoy, abuse, or harass the consumer,[255] "are directly consistent with the Act's emphasis on privacy protection."[256] In addition, the FTC included in the Proposed Rules the House Report's unambiguous statement directing the FTC to "identify other abusive practices that would be considered by the reasonable consumer to be abusive and thus violate such consumer's right to privacy."[257]

Finally, and most significantly, the FTC specifically addressed the question of its authority to promulgate rules governing "other abusive practices" that are not related to privacy when it discussed its application of its traditional unfairness analysis to the question of advance fees in the original TSR Proposed Rules. The agency acknowledged that "some of the practices prohibited as abusive under the Act flow directly from the

255. FTC Telemarketing Sales Rule Final Amended Rule, *supra* note 116, at 4613.

256. *Id.* at 4614. The FTC also acknowledged that Congress directed that these specific practices be addressed in the rules.

257. *Id.* at 4614 n.395.

Telemarketing Act's emphasis on protecting consumers' privacy."[258] However, the FTC went on to state that:

> When the Commission seeks to identify practices as abusive that are less distinctly within that parameter, the Commission thinks it appropriate and prudent to do so within the purview of its traditional unfairness analysis, as developed in Commission jurisprudence and codified in the FTC Act. This approach constitutes a reasonable exercise of authority under the Telemarketing Act, and provides an appropriate framework for several provisions of the original rule.[259]

In other words, where the agency's rulemaking exceeded the "parameter" of the privacy concerns addressed by Congress in the statute and the legislative history, the FTC apparently felt compelled to apply its traditional unfairness analysis to ensure that such rules did not exceed its Section 5 authority.[260] Otherwise, if the FTC was confident that its rules prohibiting advance fees did not exceed the rulemaking authority delegated by Congress in the TCFAPA, there would be no reason to engage in the Section 5 unfairness analysis.

IX. CONCLUSION

The FTC's attempt to promulgate debt-relief industry regulations that exceed the authority provided by the TSR is an example of the agency's campaign to expand its authority beyond the limits imposed on it by Congress. The endgame is obvious—the FTC seeks to obtain complete regulatory and enforcement discretion by obtaining the authority to freely engage in APA rulemaking and employ the threat of unlimited Section 19(b) remedies in any enforcement action. Moreover, given the FTC's stated desire to expand the availability of civil penalties beyond the limitations currently imposed by statute,[261] it can only be a matter of time before the FTC moves either to promulgate its own civil penalties or to impose such penalties under its overly inflated interpretation of Section 19(b). In

258. *Id.*

259. *Id.*

260. The agency apparently anticipates and attempts to head off this challenge, stating that "[w]hether privacy-related intrusions or concerns might independently give rise to a Section 5 violation outside of the Telemarketing Act's purview is not addressed or affected by this analysis." *Id.*

261. *See supra* note 59 and accompanying text.

short, the FTC continues "to push its statutory authority to the very brink and beyond."[262]

Despite these coordinated efforts, we anticipate that significant legal challenges will be raised to the FTC's expansionism. Objections to the agency's Section 13(b) strategy have been raised in the District of Columbia, the Northern District of California and the Ninth Circuit, and we fully expect that upon thorough review, the courts will ultimately draw the correct conclusion that the agency was never authorized to obtain expansive Section 19(b) remedies beyond the situations outlined by Section 19(a). Similarly, we expect that if the FTC continues its efforts to promulgate debt-relief industry regulations under the dubious authority of the TSR, rather than wait for express guidance from Congress, the courts will repel such efforts as a violation of the agency's statutory authority.

Given the questionable legal basis supporting the FTC's attempt to amend the TSR, and the interest the debt-settlement industry is receiving from Congress and various state legislatures, it appears that the FTC's aggressive attack on the settlement industry is motivated by political pressure exerted by special interest groups opposing the industry, rather than a genuine concern for consumers suffering a crisis of debt. As Commissioner Rosch acknowledged, there is a place for debt settlement as a tool to address consumer debt issues: the task at hand at this point is to "separate the wheat from the chaff."[263] The FTC's proposed TSR amendment does not address this task. Rather, it lays to waste the entire wheat field. Unfortunately, this scorched earth philosophy is entirely consistent with an agency that appears more focused on expanding its authority and flexing its muscles than it is with ensuring consumers have safe and available options to deal with crushing debt.

262. *See supra* note 58 and accompanying text.

264. *Transcript of FTC Debt Settlement Workshop* 14 (Sept. 25,2009) *available at* www.FTC.gov/bcp/workshops/debtsettlement/officialtranscript.pdf.

THE BEAR HUG THAT IS CRUSHING DEBT-BURDENED AMERICANS: WHY OVERZEALOUS REGULATION OF THE DEBT-SETTLEMENT INDUSTRY ULTIMATELY HARMS THE CONSUMERS IT MEANS TO PROTECT

DEREK S. WITTE*

* Professor Witte is a tenure-track Assistant Professor at the Thomas M. Cooley Law School in Grand Rapids, Michigan, where he teaches Contracts and Commercial Law. Prof. Witte participated as a panelist in the FTC Public Forum regarding the proposed FTC rules on debt-settlement in November 2009; he also provides legal counseling to members of the debt-settlement industry.

I. INTRODUCTION

By strangling the free market and substituting their own judgment for those of the American people, regulators and lawmakers are threatening one of the most important right-now solutions to America's consumer financial crisis. For-profit debt-settlement companies are the only entities that can provide consumers who cannot repay their credit card debts with a viable alternative outside of bankruptcy and the expensive, unhelpful debt-management plans offered by credit card banks and their nonprofit credit counselor allies. Even the opponents of the debt-settlement industry agree that struggling Americans need a way, short of consumer bankruptcy, to cut into the insurmountable debt created by credit card banks' aggressive and unscrupulous lending practices. Because the credit card banks and nonprofit credit counselors cannot provide such an option, America needs the services offered by debt-settlement companies. It may be tempting for lawmakers and regulators to succumb to the relentless campaign against the debt-settlement industry, but this is a campaign supported mostly by anecdotal evidence based on the conduct of a handful of bad actors and fueled by television advertisements that do not adequately represent the industry as a whole. Instead, lawmakers and regulators should recognize the importance of debt-settlement services and focus their attention on preventing misrepresentation and deceptive advertising within the industry, while allowing the *market* to set the fair price and method of payment for debt-settlement services. If they do not, then debt settlement will soon be unavailable, and debt laden consumers will ultimately suffer.

II. AMERICA IS BEING CRUSHED BY CREDIT CARD DEBT

Through unscrupulous lending practices and in the midst of a failing economy, credit card banks have burdened American consumers with an unprecedented amount of debt. Despite some signs that the nation's financial state of affairs may be improving, there is no question that the average American is still suffering through increased joblessness, sinking home values, and a slumping economy. Unemployment continues to hover at about 10%, and as of February 2010, the number of persons unemployed due to job loss had increased by 378,000 to 9.3 million.[1] In January of 2010, the housing market continued to struggle, and existing home sales were at a seven-month low.[2] During 2009, Americans were less happy and more stressed, and their stress was linked both to the failing economy and their own financial uncertainty.[3]

Were that not bad enough, American consumers now carry more unsecured credit card debt than ever before. As of late 2008, consumer debt was at an all-time high.[4] It is only slightly lowered as of the writing of this Article, holding steady at about $2.5 trillion.[5] The problem is ubiquitous—almost 80% of all households that have credit cards owe more than $10,000 in unsecured credit card debt.[6]

The poor economy, however, has merely exacerbated an extant problem. Rather, it is the longtime use of aggressive and unscrupulous lending practices by powerful credit card banks that has put Americans further into the hole than they have ever been before.[7] Between 2001 and 2008, unsecured credit card debt rose by 30%.[8] At the time, the credit card industry promised Americans that bankruptcy reform would make credit cheaper and more affordable for everyone.[9] Despite this promise, however, bankruptcy reform "profited credit card

1. Press Release, Bureau of Labor Statistics, Employment Situation Summary (Feb. 5, 2010), *available at* http://www.bls.gov/news.release.

2. Press Release, Nat'l Ass'n of Realtors, Existing-Home Sales Down in January but Higher than a Year Ago; Prices Steady (Feb. 26, 2010), *available at* http://realtor.org/press_room/news_release/2010/02/ehs_january2010.

3. Dan Witters, *Americans Less Happy, More Stressed in 2009*, GALLUP, Jan. 1, 2010, http://www.gallup.com/poll/124904/Americans-Less-Happy-Stressed-2009.aspx.

4. Federal Reserve Statistical Release, *Consumer Credit*, G.19 (Feb. 5, 2010), *available at* http://www.federalreserve.gov/releases/g19/20100205/.

5. Federal Reserve Statistical Release, *Consumer Credit*, G.19 (Mar. 5, 2010), *available at* http://www.federalreserve.gov/releases/g19/Current.

6. Ben Woolsey & Matt Schulz, *Credit Card Statistics, Industry Facts, Debt Statistics*, CreditCards.com (2009), http://www.creditcards.com/credit-card-news/credit-card-industry-facts-personal-debt-statistics-1276.php.

7. *See* Barbara Kiviat, *How Americans Got into a Credit-Card Mess*, TIME, Aug. 8, 2009, *available at* http://www.time.com/business/article/0,8599,1915015,00.html (containing a Q&A with Charles Geisst, Professor of Finance at Manhattan College, concerning the history of Americans and borrowed money).

8. Robert M. Lawless, *Did Bankruptcy Reform Fail?*, 82 AM. BANKR. L.J. 349, 350 n.3 (2008).

9. Michael Simkovic, *The Effect of BAPCPA on Credit Card Industry Profits and Prices*, 83 AM. BANKR. L.J. 1, 3 (2009).

companies at consumers' expense."[10] Credit has become more expensive, not less,[11] and lenders' actions have caused greater financial stress on their borrowers. In May of 2009, the White House stated, "[F]or too long credit card contracts and practices have been unfairly and deceptively complicated, often leading consumers to pay more than they reasonably expect. Every year, Americans pay around $15 billion in fees."[12]

The consumer credit card banks' egregious and aggressive lending practices led Congress to pass the Credit CARD Act of 2009, which purportedly protects consumers from contracts that package high interest rates with a low introductory APR to lure consumers into signing agreements that they cannot realistically afford.[13] Unfortunately, the Credit CARD Act of 2009 is full of loopholes. Banks can still raise interest rates, as long as they give consumers 45 days notice.[14] Furthermore, the penalty interest rates remain high and banks are charging increasingly more for cash advances.[15] There are already signs that the banks are finding ways to increase consumer debt and erect more and more barriers to debt-free living by increasing penalties and simply lengthening the duration of their bait-and-switch introductory offers.[16] In anticipation of the Credit CARD Act, lenders have already been raising interest rates and penalties, thus increasing the debt load on the average American

10. *Id.* at 1.

11. *Id.* at 14–16, 22 (concluding from an analysis of the data that passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of 11 U.S.C.) caused an increase in credit card rates and the profits of credit card companies). *See also* Credit Card Monitor, *Current Average Credit Card Interest Rates*, Credit Card Monitor (May 15, 2010) http://www.indexcreditcards.com/credit-card-rates-monitor/ (noting that credit card interest rates have increased in response to the passage of recent legislation).

12. Press Release, Office of the Press Sec'y of the White House, Fact Sheet: Reforms to Protect Am. Credit Card Holders (May 22, 2009), *available at* http://www.whitehouse.gov/the_press_office/Fact-Sheet-Reforms-to-Protect-American-Credit-Card-Holders.

13. Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. 111-24, May 22, 2009, 123 Stat. 1734 (2009).

14. 15 U.S.C. § 1637(i)(2). This only applies to credit card accounts under an open-end consumer credit plan. *Id.*

15. Zachary Stauffer, *Tricks & Traps of the Card Game*, http://www.pbs.org/wgbh/pages/frontline/creditcards/themes/tricks.html (last visited May 26, 2010).

16. Pew Health Group, *Still Waiting: "Unfair or Deceptive" Credit Card Practices Continue as Americans Wait for New Reforms to Take Effect* 1–3, 6–9 (Oct. 2009), http://www.pewtrusts.org/uloadedFiles/wwwpewtrustsorg/Reports/Credit_Cards/Pew_Credit_Cards_Oct09_Final.pdf

cardholder.[17]

Given that these lenders have crippled many American households, and given that the current economy is making it harder for Americans to pay down their debt, most consumers need help. Sadly, as I will discuss below, most of the options available to consumers who need help with their credit card debt have been manipulated by, or are being indirectly controlled by, the very lenders from whom consumers seek relief. As a result, people who cannot realistically pay off all of their debt—often because of exorbitant interest, fees, and penalties—need the services offered by the debt-settlement industry because that industry is the only independent option through which they can reduce their debt.

III. BANKRUPTCY IS NOT AN OPTION

More consumers than ever cannot, or will not, choose to enter individual bankruptcy when they are unable to pay off their credit card debt. Today, debt-burdened consumers are less likely to file for bankruptcy protection because they: 1) cannot qualify for bankruptcy under the new reformed laws; 2) are discouraged by the procedural hurdles to individual bankruptcy; or 3) are unwilling to live with the stigma associated with bankruptcy. For whatever reason, more individuals are struggling with debt outside of bankruptcy than ever before.[18]

Traditionally, when an individual's debt outgrew their income and they lost all realistic hope of ever repaying their creditors, they could file for bankruptcy. Through Chapter 7, individuals would receive a fresh start so long as they surrendered their assets to the court.[19] Chapter 13, on the other hand, gave the court special powers to forgive or modify portions of the individual's debt obligations, while still requiring the individual to repay as much of the debt as possible.[20] Bankruptcy reform has made these options less available.

17. *Id.* at 1, 25.

18. Lawless, *supra* note 8, at 350–51.

19. Scott F. Norberg, *Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13*, 7 AM. BANKR. INST. L. REV. 415, 420–22 (1999).

20. *Id.* at 423–25.

In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).[21] According to its proponents, it was intended to prevent individuals would could repay their debts from gaming the system.[22] Its supporters, including former President George W. Bush, argued that by forcing those who could pay their debts to do so and preserving bankruptcy for those truly in need, it would lower the cost of credit and help everyone.[23] Unfortunately, BAPCPA has failed.[24] It does not screen those who can pay their debts from those who cannot. Instead, it discourages everyone, regardless of income, from filing for bankruptcy.[25]

As a result of BAPCPA, more consumers in need are struggling outside of bankruptcy for longer periods of time, thus increasing credit card banks' revenue. BAPCPA discourages bankruptcy filings not only by making it harder to qualify for Chapter 7,[26] but also by erecting procedural hurdles to filing, such as mandatory credit counseling, longer waiting periods between permitted filings, and a lot more paperwork.[27] Professor J.J. White from the University of Michigan has described this as a "death by a thousand cuts through low-visibility procedural burdens."[28] The end result is that BAPCPA has made bankruptcy less available for individuals suffering under insurmountable credit card debt.

BAPCPA, however, is not the only reason why bankruptcy is not an option for many consumers. Despite arguments to the contrary, many individuals who likely could qualify for post-reform individual bankruptcy still refuse to do so because of the social stigma attached to bankruptcy.[29] In a recent study,

21. Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of 11 U.S.C.); *e.g.*, 11 U.S.C. § 707 (means test under revised bankruptcy code).

22. Lawless, *supra* note 8, at 351–52.

23. Simkovic, *supra* note 9, at 2–3.

24. Lawless, *supra* note 8, at 385–86; Simkovic, *supra* note 9, at 22–24.

25. Lawless, *supra* note 8, at 353, 385–86.

26. *Id.* at 352 (discussing the imposition of a "means test" that examines expenses and income as determinative for transfer to Chapter 11 or 13); *see* Patricia Sabatini, *New Law's 'Means' Test Just Mean, Bankruptcy Experts Say*, PITTSBURGH POST GAZETTE, Apr. 26, 2005, E-1.

27. 11 U.S.C. §§ 109(h)(1), 521, 727(a)(11), 1328(g) (2006). *See also* Lawless, *supra* note 8, at 380 (restating the new requirements imposed by BAPCPA); Simkovic, *supra* note 9, at 2.

28. Lawless, *supra* note 8, at 380 (citing James J. White, *Abuse Prevention 2005*, 71 MO. L. REV. 863 (2006)).

29. *Id.* at 384.

sociologists concluded that people who file for bankruptcy still experience social stigma, and that society may view—and thus treat—those who file for consumer bankruptcy as deadbeats who "rip off the system."[30] The bankrupt families that were the subject of this study viewed bankruptcy as a failure.[31] If their views are indeed common, then it is more than reasonable to conclude that there are many others with substantial consumer debt who choose not to file for fear of being stigmatized by their peers, friends, and neighbors.[32]

Whether due to social stigma or BAPCPA, as the 2007 Consumer Bankruptcy Project concluded, "it is clear that families are not turning to bankruptcy even when they have great need."[33]

IV. TRADITIONAL DEBT MANAGEMENT IS NOT FOR EVERYONE

Many consumers struggling with debt cannot qualify for the traditional debt management plans offered by nonprofit credit counselors. For years, credit card banks have offered "debt management plans" to those who cannot repay their credit card

30. Deborah Thorne & Leon Anderson, *Managing the Stigma of Personal Bankruptcy*, 39 SOC. FOCUS 77 (2006) (analyzing "face-to-face interviews of 37 individuals from 19 married couples who had filed joint petitions for personal bankruptcy . . . within three months of the couples' bankruptcy filings"). Thorne & Anderson note that the thirty-eighth interviewee "hid upstairs [and declined to be interviewed] because, as his wife said, he was ashamed of their bankruptcy." *Id.* at 80.

31. *Id.* at 93.

> Our findings are clear. Feelings of stigmatization were a pervasive feature of our informants' bankruptcy experiences . . . . Significantly, these comments emerged without specific prodding from the interviewer regarding stigmatization. Further, our informants exhibited many classic techniques documented in previous sociological literature for attempting to manage stigma. They strived to conceal their spoiled identities, especially from particularly significant others. Fearing embarrassment, they avoided interactions with those who might know of their recent failings. . . . [T]hey distanced themselves from stereotypical images of illegitimate bankruptcy filers, provided excuses and justifications for their own bankruptcies, and described their attempts at activities that would enable them, at least partially, to transcend their stigmatized identities.
>
> Our findings contrast with the economic model of personal bankruptcy motivation associated with the loss of stigma argument. . . . While bankruptcy is clearly an act in which economic concerns figure prominently, those who declare bankruptcy do so within a culture context of shame, embarrassment, and assertions of their moral failure. *Id.* at 93–94.

Thorne and Anderson also noted that their findings were consistent with other studies. *Id.*

32. *Id.*

33. Lawless, *supra* note 8, at 386.

debt. These plans are most often offered through nonprofit credit counselors, who act as intermediaries between banks and consumers.[34] After undergoing counseling and budgeting education, an individual who qualifies for a debt management plan makes one monthly payment to the debt management plan provider, who then distributes portions of the payment to each of the consumer's lenders.[35] To make this single payment more affordable, the banks purportedly lower interest rates on the consolidated debt.[36] In the past, banks were willing to eliminate almost all interest for those who qualified for a debt management plan.[37] Recently, however, interest rates on debt that has been consolidated into a debt management plan have steadily risen.[38] The debt management plan drafts payments directly from the individual's checking account, making payments more regular and predictable.[39] If the individuals make all of their payments and do not continue to charge expenses to their credit cards, then they will usually be debt-free within sixty months.[40]

This process appears quite innocuous and on its surface seems to provide struggling consumers with a way to get out of debt. However, nonprofit credit counselors and the debt management programs that they offer do not provide an overwhelming benefit to consumers. Instead, these programs just provide banks with one more chance to squeeze money from nonpaying

34. *Consumer Protection and the Credit Crisis: Hearing Before the S. Comm. on Commerce, Science, & Transportation*, 111th Cong. 10–11 (2009) [hereinafter *Hearing*], (statement of Hon. Pamela Jones Harbour, Commissioner, Federal Trade Commission).

35. *Id.* at 11 n.31.

36. Tara Siegel Bernard, *Weighing the Options with Credit Card Debt*, N.Y. TIMES, May 16, 2009, at B6, *available at* http://www.nytimes.com/2009/05/16/your-money/credit-and-debit-cards/16counsel.html.

37. *Id.*

38. DEANNE LOONIN & TRAVIS PLUNKETT, CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR. INC, CREDIT COUNSELING IN CRISIS: THE IMPACT ON CONSUMERS OF FUNDING CUTS, HIGHER FEES AND AGGRESSIVE NEW MARKET ENTRANTS 22 (Consumer Fed'n of Am. & Nat'l Consumer Law Center, Apr. 2003), *available at* http://www.consumerfed.org/pdfs/credit_counseling_report.pdf ("[C]reditor policies on reducing interest rates vary tremendously. . . . Most major credit card issuers have raised their interest rates in credit counseling or kept them above 9 percent in the last few years, although Chase Manhattan and Providian are notably bucking this trend.").

39. *Id.* at 8 (noting that competition from "newcomers" to the industry has spurred debt-settlement companies to "pioneer[] more business-like methods of making debt management plans convenient for consumers, including flexible hours, phone and Internet counseling, and electronic payments").

40. *E.g.*, Hummingbird Credit Counseling and Education, Debt Management Plans, http://www.hummingbird.org/learning/financialalts/?id=5 (last visited May 26, 2010).

customers. The most important and often hidden fact is that many nonprofit credit counselors are funded by the credit card companies themselves.[41] The credit card companies created the entire industry as an additional way to collect overdue debt.[42] Traditionally, the credit card companies support the nonprofits through regular "fair share" payments made directly to the credit counselors.[43] Nonprofit credit counselors now claim that fair share payments have diminished.[44] However, it seems that the credit cards have simply replaced the controversial fair share payments with large "grants" to the national nonprofit credit counseling companies.[45] Whether through fair share payments or grants, the banks fund the nonprofit credit counselors.[46]

Trusting that these counselors have their best interest in mind because of their "nonprofit" status, consumers walk voluntarily into the lion's den. Nonprofit credit counselors, who have the opportunity to see the individual's budget and spending habits as part of their budgeting and "education" services, may use this information to squeeze as much money as possible out of the consumers on behalf of the credit card companies.[47] In addition to the money they receive from the credit cards, the counselors also keep a sizeable amount of money for themselves through DMP fees.[48] Although some nonprofit credit counselors are genuinely concerned about their clients and focus their efforts on counseling and budgeting, many large regional and

41. *Hearing*, *supra* note 34, at 33–34 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America); *see also* Mary Kane, *Ties Run Deep Between Subprime Lenders, Financial Literary Groups*, THE WASH. INDEP. Nov. 12, 2009.

42. *Hearing*, *supra* note 34, at 33 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

43. Hummingbird Credit Counseling and Education, *supra* note 40.

44. LOONIN & PLUNKETT, *supra* note 38, at 10 (citing earlier reports drafted by the Consumer Federation of America and the National Foundation for Credit Counseling).

45. *See Transcript of FTC Public Forum on Debt Relief Amendments to the Telemarketing Sales Rule* 77 (Nov. 4, 2009) (statement Jane McNamara) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001); *Hearing*, *supra* note 34, at 33 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

46. Allen Mattison, Note and Comment, *Can the New Bankruptcy Law Benefit Debtors Too? Interpreting the 2005 Bankruptcy Act to Clean Up the Credit-Counseling Industry and Save Debtors from Chronic Poverty*, 13 GEO. J. ON POVERTY L. & POL'Y 513, 523–24 (2006).

47. *See* LOONIN & PLUNKETT, *supra* note 38, at 31 (noting potential violations by credit counseling agencies of the restrictions imposed by their nonprofit status and alarming connections with for-profit lenders).

48. *See Legislative Highlights: Pension Reform Charges Airline and Credit Counseling Requirements*, AM. BANKR. INST. J., Sept. 2006, at 8.

nationwide credit counselors are designed to maximize revenue from the credit card banks and consumers.[49]

In either case, nonprofit credit counselors are paid to enroll nonpaying or struggling borrowers into a monthly payment plan that utilizes direct drafts from the borrower's checking account. To many regulators, this may have sounded a lot more like debt collection than nonprofit credit counseling. It is thus no surprise that the FTC and the IRS cracked down on false nonprofit credit counselors who were simply pushing consumers into debt management plans and hiding from tax liability by claiming that they were primarily "educating" consumers.[50] Despite this crackdown, some nonprofit credit counselors continue to defraud consumers.[51]

What is even more troubling is that only about one quarter of the individuals who enter debt management programs successfully complete them.[52] In addition, because a debt management plan requires consumers to pay back all of their principal debt, *plus* a lowered amount of interest to the banks, *plus* a monthly service fee paid to the plan itself, many individuals who are truly struggling with their debt don't even qualify for traditional debt management in the first place.[53] These plans are just too expensive. They do not offer realistic help to struggling consumers.[54]

Given that fewer consumers than ever even qualify for debt management plans, given that only about one quarter of those who even enter into those plans actually finish, and given that the nonprofit credit counselors who sell those plans are no more than an arm of the credit card banks themselves, most consumers cannot, or should not, turn to a traditional debt

49. S. REP. NO. 109-55, at 1–4 (2005).

50. *Id.*

51. Long after the purported house cleaning of the non-profit credit counseling industry, the FTC continued to successfully bring enforcement actions against so-called non-profit credit counselors. *Hearing*, *supra* note 34, at 11 (statement of Hon. Pamela Jones Harbour, Commissioner, Federal Trade Commission).

52. Robert M. Hunt, *Whither Consumer Credit Counseling?*, BUSINESS REVIEW, Q4 2005, at 9, 13, (noting that "approximately one-half of debt management plans fail after about six months").

53. *Transcript of FTC Debt Settlement Workshop* 6 (Sept. 25, 2008) (statement of Lydia Parnes) ("Although the number of consumers contacting [non-profit credit counselors] about debt has increased by about 33 percent, the percentage of consumers who meet the income requirement for debt management plans is down over 40 percent.").

54. *Hearing*, *supra* note 34, at 27–43 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

management plan when they are being crushed by credit card debt.

V. DEBT SETTLEMENT IS THE MIDDLE-GROUND OPTION THAT AMERICA NEEDS.

American consumers who cannot or will not enter into bankruptcy and cannot qualify for a traditional debt management plan need the help that only honest debt-settlement companies can provide. The consumers who especially need help are people who, even over several years, do not have enough income to pay off the full balance they owe but do not qualify for bankruptcy after BAPCPA. Respected debt-relief industry leaders and consumer rights' advocates both agree that struggling Americans need a non-bankruptcy way out of debt that does not require them to re-pay their full debt balance since the equivalent principal amount has often been paid in the form of interest.[55] What is puzzling is that the same people who are demanding this option will not admit that debt-settlement offers this middle ground. Perhaps this is because debt settlement's critics are funded by the credit card companies themselves and are thus invested in preventing consumers from having an option that is truly independent from the credit cards.[56] For this reason, Georgetown Law Professor Adam Levitan recently stated that he would trust a for-profit debt-settlement company to assist a consumer with credit card debt before he would trust a nonprofit credit counselor funded by the credit card companies themselves.[57]

If one takes a step back and looks at the entire debt-relief marketplace, it seems clear that a wisely-regulated debt-settlement industry provides the middle-ground solution that America needs. By helping consumers take advantage of the routine willingness of credit card banks to discharge a consumer's entire debt for a lump sum payment totaling far less

55. *See Transcript of FTC Public Forum on Debt Relief Amendments to the Telemarketing Sales Rule* 143 (Nov. 4, 2009) (statement of William Binzel) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001); *Hearing*, *supra* note 34, at 29 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America, that "Consumers want something that gives them more assistance [than] credit counseling that stops short of bankruptcy").

56. *See supra*, Part III.

57. *Hearing*, *supra* note 34, at 33–34; *see also* Kane, *supra* note 41.

than the amount owed,[58] debt-settlement companies provide the only service outside of bankruptcy that allows customers to cut into the principle of the debt they owe. Although their critics argue that the debt-settlement industry provides little value to consumers, debt-settlement companies regularly settle their customers' credit card accounts in exchange for lump-sum payments of substantially less than the total amount owed by cardholders.[59] A New York state court recently held that when a debt-settlement company bargains down a consumer's debt, it is indeed providing real value to that consumer.[60] It is thus no surprise that in late 2008 FTC Commissioner Rosch noted that "debt settlement, even at a cost, can play an important role in solving what may seem like insurmountable problems of indebtedness faced by many consumers."[61]

Remarkably, the nonprofit credit counselors and consumer advocates who routinely criticize the debt-settlement industry actually admit that the concept of debt settlement is sound and provides struggling Americans with what they need. At a recent FTC public forum held to elicit commentary from the debt-relief industry and its experts, William Binzel, President of the National Foundation of Credit Counselors (NFCC) and an outspoken critic of the debt-settlement industry, said: "I think there is a consensus in this room . . . that the product of debt settlement in itself, whether we call it debt settlement or less than full balance settlement, whatever that is, there is a

58. *See, e.g.*, *Transcript of FTC Debt Settlement Workshop* 87 (Sept. 25, 2008) (statement of Jack Craven); Jane Birnbaum, *Debt Relief Can Cause Headaches of Its Own*, N.Y. TIMES, Feb. 9, 2008, at C1.

59. RICHARD A. BRIESCH, ECONOMIC FACTORS AND THE DEBT MANAGEMENT INDUSTRY 2–3 (Americans for Consumer Credit Choice, Aug. 6, 2009); *see also* Letter from Richard A. Briesch to FTC (Oct. 27, 2009), *available at* http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00306.pdf (regarding proposed amendment to the Telemarketing Sales Rule number R411001).

60. *People v. Nationwide Asset Servs., Inc.*, 888 N.Y.S.2d 850, 867, 870–71 (N.Y. Sup. Ct., Erie County 2009). This was an especially remarkable holding given that the court found that the debt-settlement company defendant had engaged in consumer fraud. If a debt-settlement company that has been found to have defrauded consumers in the State of New York can still provide value to its customers by reducing their credit card debt, then certainly the other members of the industry can be a real part of the solution to the current economic crisis.

61. *Transcript of FTC Debt Settlement Workshop* 6 (Sept. 25, 2008) (statement of J. Thomas Rosch). I would submit that debt settlement can only be offered "at a cost" and only in a wisely regulated and functioning market can that "cost" be determined. Nonetheless, the Commissioner's statements emphasize that honest debt settlement is indeed part of the solution. *Id.*

consumer need for that."[62] Likewise, Travis Plunkett, of the Consumer Federation of America,[63] who—based only on anecdotes and a handful of enforcement actions against sham debt-settlement companies—has aggressively criticized the debt-settlement industry in front of the Federal Trade Commission, U.S. Senate, and other regulatory and law-making bodies; has been pleading for a debt-relief option short of bankruptcy that will cut into the principal that consumers owe to their credit card banks.[64] Yet, like the nonprofit credit counselors, Mr. Plunkett wants the banking regulators to allow the credit card banks, not the debt-settlement companies, to offer this product in a way that will help their bottom line and allow them to avoid writing off these accounts as losses.[65]

A. *The Banks Will Not Offer a Less-Than-Full-Balance Debt-Settlement Product*

The fact is, however, that neither the banks nor the nonprofit credit counselors[66] will realistically offer a "less-than-full-balance" recovery option to debt-strapped consumers.

If a credit card borrower fails to make his or her minimum payments for six months, they are considered to be in default.[67] Once a borrower is in default, the Office of the Comptroller of the Currency Administrator of National Banks (OCC), which regulates the credit card banks, requires the lenders to write off the defaulted account as a "loss" in their accounting records.[68]

62. *Transcript of FTC Public Forum on Debt Relief Amendments to the Telemarketing Sales Rule* 143 (Nov. 4, 2009) (statement of William Binzel) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001).

63. The Consumer Federation of America describes itself as an advocacy, research, education, and service organization, with members who include non-profit organizations. CFA testifies on consumer issues before legislative and regulatory bodies, investigates and provides research on consumer issues, and disseminates information on consumer issues to the public and the media. *See generally* Consumer Federation of America, http://www.consumerfed.org/about/default.asp (last visited May 26, 2010).

64. *Hearing*, *supra* note 34, at 34 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

65. *Id.* (urging the bank regulators to "quickly create a regulatory path that would allow and encourage issuers to offer reduced principal DMPs").

66. *See infra*, Part IV.B.

67. For a general overview of mark-to-market presorting and Generally Accepted Accounting Principles (GAAP), *see Mark-to-Market Accounting: Practices and Implications: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises*, 111th Cong. 19–58 (2009) (testimony of Kevin J. Bailey, Deputy Comptroller, Office of the Comptroller of the Currency).

68. *Id.*

Once the account is a loss, the bank can do whatever necessary to recover as much of the defaulted debt as possible, including settling the debt or selling it to a collection company or debt buyer for pennies on the dollar.[69] Currently, banks do not admit that they are accepting less than the total amount owed in full discharge of the debt and often try to make it appear as if they are not bargaining with debt-settlement companies, either by selling the debt off to debt buyers who then settle the debt themselves or by settling the debt through affiliates.[70] Yet, having been forced to write off the defaulting accounts as a loss, the credit card companies continue to settle debt when faced with a consumer or a debt-settlement company that is willing to stand their ground and bargain down the debt.[71]

Although the banks could agree right now to offer an institutional "product" to distressed borrowers that would allow them to discharge their defaulted debt by paying less than what they owe, this would be like a bank saying: "We'll give you a credit card and if you charge more than you can repay, then you don't have to pay it all back." It is unthinkable for a credit card company to take this position as a matter of policy. Indeed, it would be bad for the banks, their owners, and their investors. Instead, it seems that, other than through adversarial debt settlement, banks would only offer a less-than-full-balance debt-relief option if they could avoid writing off the defaulted accounts as losses and thus appear more profitable. In a letter to the OCC, the Consumer Federation of America and the Financial Services Roundtable requested that the OCC give credit card companies and nonprofit credit counselors permission to do this very thing.[72]

The OCC, however, voiced concerns that "major lenders and credit counseling agencies . . . are failing to differentiate between working with distressed borrowers and a desire to simply acquire forbearance on loss recognition."[73] As a result,

69. Liz Pulliam Weston, *Credit card debt: How to cut a deal*, MSN MONEY, Mar. 5, 2010.

70. *Id.*

71. DEANNE LOONIN & JULIA DEVANTHERY, THE LIFE AND DEBT CYCLE 19 (National Consumer Law Center, Sept. 2006).

72. Letter from Timothy W. Long, Senior Deputy Comptroller, Bank Supervision Policy and Chief Nat'l Bank Examiner, Office of the Comptroller of the Currency, to Scott Talbot, Senior Vice President, The Financial Services Roundtable and Travis Plunkett, Legislative Director, Consumer Federation of America (Nov. 10, 2008) (on file with author).

73. *Id.*

the OCC stated that "banks certainly have the option to offer principal relief as long as the loans are accounted for off-balance sheet [recorded as losses] with any repayment recorded as a recovery."[74] In other words, the OCC said "no." For this reason, it appears that banks will not be able to offer a less-than-full-balance debt-relief option directly to struggling consumers.

B. *Nonprofit Credit Counselors Cannot Offer Debt-Settlement Services*

For this same reason, the nonprofit credit counselors cannot offer a less-than-full-principal debt-relief option either. The only way that a consumer can cut into the principal of the debt that they owe to a credit card lender is for the consumer—alone or with the help of a strong consumer advocate, like a debt-settlement company—to stand up to the credit card company in a truly adversarial posture and bargain for the debt reduction. Nonprofit credit counselors cannot advocate for consumers by taking on the credit card companies, because they are funded and controlled by the credit card companies.[75] Thus, if the credit card companies do not offer a product like debt settlement to struggling borrowers—and they will not, since OCC will not allow it—then neither will nonprofit credit counselors.

Beyond their inability to bite the hand that feeds them, nonprofit credit counselors also cannot offer true less-than-full-principal debt-settlement services because doing so would threaten their nonprofit status. If a tax-exempt nonprofit were to engage in adversarial negotiations with a lender in order to reduce a consumer's debt, the nonprofit would be stepping outside of their recognizable tax-exempt function and engaging in pecuniary activity that would necessarily be subject to corporate taxation.[76]

Therefore, only for-profit debt-settlement companies can provide Americans with the middle-ground debt-relief option that they need.

74. *Id.*

75. *See supra* notes 41–51 and accompanying text.

76. *See* Robert Davis, FTC Public Comment on Notice of Proposed Rulemaking (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001).

VI. BIASED CRITICISM HAS LED TO OVER-REGULATION OF THE DEBT-SETTLEMENT INDUSTRY

Nonprofit credit counselors and consumer advocacy groups have created a mob mentality when it comes to the debt-settlement industry.[77] Although credit counselors and consumer advocates actually agree that the concept of debt settlement, which they refer to as "less than full principal recovery," is good for the United States,[78] they have somehow turned "debt settlement" into a dirty phrase. Whenever given the opportunity, these groups have demanded that debt settlement be made unlawful. In fact, it seems that the NFCC has been lobbying the Senate, White House and the FTC in an effort to outlaw or severely limit the services that debt settlement can provide to struggling consumers.[79]

State attorneys general, lawmakers, the FTC and other regulators should not give much weight to criticism from the NFCC and other credit counseling companies because the credit card companies indirectly control these nonprofits. Such criticism should also be disregarded because credit counselors believe that if debt settlement did not exist, more consumers would be forced into credit counseling: either through the mandatory counseling required under the reformed bankruptcy provisions or as debt management plan customers. In other words, nonprofit credit counselors compete against debt-settlement companies, and thus their criticism should be taken with a grain of salt.[80] In addition, credit counselors and

77. *See* National Foundation for Credit Counseling: Consumer Alert, http://www.nfcc.org/consumeralert (last visited May 26, 2010) (claiming that debt settlement is not trustworthy without substantiating or supporting these broad stroke conclusions); *see also* South Brooklyn Legal Services, FTC Public Comment on Notice of Proposed Rulemaking, at 1 (Oct. 26, 2009), (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001); Susan Grant, FTC Public Comment on Notice of Proposed Rulemaking (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001); *Hearing*, *supra* note 34, at 34–37 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

78. *Transcript of FTC Public Forum on Debt Relief Amendments to the Telemarketing Sales Rule* 143 (Nov. 4, 2009) (statement of William Binzel) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001); *Hearing*, *supra* note 34, at 34 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

79. *E.g.*, Lobbying Report of the National Foundation for Credit Counseling Q1–Q4 (2009) (disclosing that the NFCC lobbied the U.S. House, the Senate, the Executive Office of the President, the FTC, and the OCC regarding "regulation of the for-profit counseling and debt settlement industry").

80. When non-profits that are primarily concerned with revenue compete in an established market, the playing field is skewed, and the for-profit players are eventually squeezed out, leaving a monopoly controlled by the non-profits. This is especially

consumer advocates point only to a handful of successful enforcement actions against bad actor debt-settlement companies and anecdotal evidence from consumers when criticizing debt settlement.[81] Yet, they fail to substantiate why their anecdotal conclusions should be applied to all debt-settlement companies across the board and also ignore the real-life stories from individuals who have been saved by debt settlement. One such example was presented by Credit Solutions, Inc. in support of its opposition to pending FTC rules governing debt settlement:

> [Debt settlement] gave us a life line and has been helping us settle our debt by allowing us to save our money in our bank and paying our creditors directly from our bank . . . . We are truly thankful there was a program available when we had no other option except bankruptcy.[82]

Unfortunately, the nonprofit credit counselors' message has taken hold. This general conclusion—that the business model of debt settlement is *per se* unlawful—has found its way into actual complaints filed by state attorneys general.[83] Yet it makes

---

troublesome in the area of debt relief because the non-profits are controlled by the credit card companies. Thus, if the non-profits succeed in eliminating debt settlement, consumers will not be able to work with any company that is truly on their side and independent from the credit card companies.

81. *See, e.g.*, Aleksandra Todorova, *Debt Settlement: A Costly Escape*, MSN MONEY, Aug. 6, 2007 (criticizing debt-settlement companies' high drop-out rates via admittedly anecdotal evidence and warning services may be illegal in some states without reference to empirical data or enforcement actions). A recent FTC notice of proposed rulemaking heavily criticized the debt-settlement business model, basing its claims on statements and submissions from the Consumer Federation of America and the NFCC, among others. Telemarketing Sales Rule, 74 Fed. Reg. 41988, 41993–97 (proposed Aug. 19, 2009) [hereinafter Telemarketing Sales Rule] (to be codified at 16 C.F.R. pt. 310). In doing so, the FTC supported its assertions about the debt-settlement industry by repeatedly citing to a small number of enforcement actions that had been brought against bad actors. *E.g., id.* at 41966 nn.108–17 (continually citing FTC v. Debt-Set, Inc., No. 07-00558 (D. Colo. 2007); FTC v. Dennis Connelly, No. 06-701 (C.D. Cal. 2006); FTC v. Innovative Systems Technology, Inc., No. 04-0728 C.D. Cal. 2004); FTC v. Jubilee Fin. Servs., Inc., No. 02-6468 (C.D. Cal 2002)). It is also worth noting that "[a]ll these cases ended in settlement orders." J. Thomas Rosch, Commissioner, Fed. Trade Comm'n, Remarks before the 4th Annual Credit and Collection News Conference 6 n.13 (Apr. 2, 2009). *But cf.* Telemarketing Sales Rule, at 41997 (noting a number of state actions that have resulted in a variety of outcomes).

82. Credit Solutions of America, FTC Public Comment on Notice of Proposed Rulemaking 27 (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendment R411001).

83. *See, e.g.*, Fed. Trade Comm'n Notice of Proposed Rulemaking, 74 Fed. Reg. 41988, 41996 (Aug. 19, 2009) (concluding broadly that debt settlement is likely to harm consumers based only on a handful of enforcement actions against bad actors within the industry); Press Release, Ill. Attorney Gen., Attorney Gen. Madigan Continues Crackdown on Debt Settlement Indus. (Sept. 30, 2009) [hereinafter Ill. Attorney Gen.],

no more sense for consumer advocacy groups, regulators, and opponents of debt settlement to write off an entire industry based upon a handful of anecdotes and successful enforcement actions than it does to conclude that *all* nonprofit credit counselors are gaming the system and harming consumers simply because *some* of them are.[84] Regulators and lawmakers should recognize that the same organizations and experts who criticize debt settlement inconsistently admit that the debt-settlement product is good for consumers. What's more, the nonprofit credit counselors who are so eager to criticize the debt-settlement companies would like the opportunity to sell a "less than full principal" debt-relief product themselves.[85]

Proponents of the debt-settlement industry do not defend misleading late night television advertisements, nor do they advocate for regulation that would allow deceptive or misleading advertising.[86] However, they would assert that this often-repeated statement that the debt-settlement business model is inherently wrong[87] or harmful to consumers must be debunked once and for all. To argue that "all debt-settlement companies are bad because some of them are" is to fall prey to the logical

available at http://www.illinoisattorneygeneral.gov/pressroom/2009_09/20090930.html (concluding broadly that debt settlement is not trustworthy and conspicuously directing consumers to contact the NFCC for a "legitimate credit counseling firm"); Press Release, N.Y. Attorney Gen., Attorney Gen. Cuomo Announces Nationwide Investigation into Debt Settlement Indus. (May 7, 2009) [hereinafter N.Y. Attorney Gen.], *available at* http://www.ag.ny.gov/media_center/2009/may/may7a_09.html (claiming that debt settlement is "inherently flawed" before the investigation had even been completed and suggesting in the same press release that consumers should instead contact a "certified credit counselor").

84. "[T]he IRS has found that many credit counseling organizations operating as tax-exempt charities are now primarily sellers of debt-reduction plans, motivated by profit, and offering little or no counseling or education." Internal Revenue Service, Treas. Dep't, Credit Counseling Compliance Project at 1 (May 15, 2006), *available at* http://www.irs.treas.gov/pub/irs-trege/cc-report.pdf (Of 63 cases examined, the IRS proposed revocation of 32 and actually revoked the non-profit status of 9 non-profit credit counselors).

85. *Transcript of FTC Public Forum on Debt Relief Amendments to the Telemarketing Sales Rule*, at 49 (Nov. 4, 2009) (statement of Jane McNamara) (regarding Proposed Debt Relief Amendment R411001).

86. *Transcript of FTC Debt Settlement Workshop* 137–39 (Sept. 25, 2008) (statement of Wesley Young, Legislative Director, The Ass'n of Settlement Cos.(TASC)) (noting that the position of TASC would be to disallow its members to present advertising resembling a proffered example and that in any case TASC requires its members to provide their customers with full price disclosure prior to their agreeing to enter a debt-settlement program).

87. It appears that this concept has been pushed by, among others, the Consumer Federation of America. *Hearing, supra* note 34, at 34 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

fallacy of accident or *secundum quid*. Besides, this argument would apply equally to the nonprofit credit counseling industry, which has been rife with fraud and abuse.

Sadly, if regulators and lawmakers continue assuming that the business of debt settlement is inherently wrong and should be prohibited altogether, rather than focusing their actions on the opportunists and bad actors that do exist within the debt-settlement industry (just as they exist in the nonprofit credit counseling industry), then consumers will ultimately be harmed. The eradication of the debt-settlement industry will remove the middle-ground option for Americans burdened by debt. Instead, these debtors will be forced to suffer outside of the bankruptcy system for much longer, [88] facing destitution while padding credit card companies' pockets. Or worse, they may consider even more extreme alternatives.[89]

VII. A BETTER SOLUTION: REGULATING ADVERTISING AND MARKET TRANSPARENCY

Regulators and lawmakers should focus on eliminating the bad actors in debt settlement by regulating advertising and the transparency of the debt-settlement market, but must allow the market to set prices through honest and fair competition. As a result of the organized attack on the entire debt-settlement industry, and likely fueled by the unfortunate television advertising that antagonizes debt settlement's critics but does not fairly represent honest industry players, state and federal lawmakers are threatening to eliminate the industry altogether. Several states are either bringing or considering enforcement actions intended to put existing debt-settlement companies out of business altogether. These lawsuits are not only fueled by the rhetoric from the NFCC and the Consumer Federation of America but are also likely motivated by political ambition, as evidenced by the sensationalist press releases from various

88. *See, e.g.*, Ronald J. Mann, *Consumer Bankruptcy & Credit in the Wake of the 2005 Act: Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 398 (showing the declining rates of bankruptcy between 2004 and 2006).

89. United States Organizations for Bankruptcy Alternatives (USOBA), FTC Public Comment on Notice of Proposed Rulemaking 31, n.51 (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendment R411001). The USOBA stated "that an incredible 47% of employees surveyed reported that debtors had mentioned suicide as a possible way of addressing their debt problem." *Id.* It is worth noting that this figure was presented without much context, but nevertheless the frequency is striking. *Id.*

regulators.[90] To the extent that these actions are intended only to prevent fraud and misrepresentation and thus to allow consumers to make meaningful choices about what debt-relief options are truly best for them, they are worthwhile. However, it seems that these regulatory actions are not limited to controlling the transparency of a functioning market. Instead, they allege that debt settlement is inherently odious[91] and seek disgorgement of almost all revenues received by these companies, despite the fact that these companies provide real value.[92] These actions are threatening the industry and unfairly burdening the honest firms who are actually helping consumers.

Of greater concern, however, are several proposed or newly-enacted statutes governing the industry that actually cut into the free market and limit the revenues and methods of payment that consumers are willing to provide for debt settlement. These statutes "regulate" debt settlement in one of two ways: either by setting a cap on the fees that can be charged or by banning prepayment of fees, which the regulators define as fees paid to a debt-settlement company before a customer has settled a credit card account with his or her bank.

Statutes that set a maximum amount that debt-settlement companies may lawfully charge are very troublesome. For instance, a recently passed Oregon statute and its accompanying rules prohibit a debt-settlement company from charging more than sixty-five dollars per month for bargaining down a consumer's debt,[93] a service that takes a substantial amount of time and effort to provide. Even the Uniform Debt Management Services Act (UDMSA), which has been enacted in some form in Colorado, Delaware, Nevada, Rhode Island, Tennessee, the U.S. Virgin Islands, and Utah, threatens the free market because it limits the fees that can be charged to

90. *Supra* note 83 and accompanying text.

91. New York Attorney General Andrew Cuomo stated the debt-settlement industry was "inherently flawed" before his investigation had even been completed. N.Y. Attorney Gen., *supra* note 83.

92. The Attorney General for the state of New York sought disgorgement of all fees paid to the debt-settlement defendant on behalf of New York consumers. People v. Nationwide Asset Servs., Inc., 888 N.Y.S.2d 850, 870–71 (N.Y. Sup. Ct., Erie County 2009). The court denied the request and held that the company was entitled to be paid for reducing its customers' debts and that disgorgement for amounts paid that did not actually exceed the amount of debt originally owed by the customers should not be disgorged. *Id.*

93. OR. REV. STAT. §§ 697.062, 697.692 (2009); OR. ADMIN. R. 441-910-0099 (2009).

approximately 30% of the difference between the original debt and the reduced debt.[94] It appears, however, that the industry is comfortable with the fee caps in the UDMSA, because the market prices set within a functioning marketplace would fall below this amount.[95]

Similarly, if the proposed FTC debt-settlement rules are promulgated as written, then debt-settlement companies nationwide will be forced into the likely unsustainable position of being forced to provide debt-settlement services for free to consumers between the time of enrollment and settlement, notwithstanding the amount of work that the companies perform during that time. Although the FTC's proposed ban on advanced fees[96] is arguably less harmful than arbitrary fee caps, the FTC rules would allow consumers to enroll in debt-settlement programs and then cancel before settlement, thus avoiding any obligation to pay for the services they have received.[97] The moral hazard is obvious: consumers could cancel at the eleventh hour because they had not saved enough money to actually settle or, worse yet—in order to take advantage of the hard work performed by the debt-settlement company—by settling the debt directly with the credit card company themselves. Whatever the reason for such dishonest conduct, the market would be better served by regulation that rewards debt-settlement companies for their work and that simultaneously encourages consumers to participate in the process in good faith. Furthermore, the FTC rules will not preempt any state regulations that cap fees.[98] Thus, in states with an artificially low fee cap, debt-settlement companies would not only be prohibited from receiving fees for the work as they perform it but would also be limited by an arbitrary ceiling on the fees that they charge. Thus, it comes as no surprise that an industry survey reports if the FTC's proposed rules are promulgated, 84% of debt-settlement companies will "almost certainly" be forced out of business because they cannot afford

94. Unif. Debt-Mgmt Serv. Act § 23 (2008).

95. The Ass'n of Settlement Cos., FTC Public Comment on Notice of Proposed Rulemaking 5, 19 (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001).

96. FTC Proposed Rules, 74 Fed. Reg. 41988, 42008–09 (Aug. 19, 2009) (to be codified at 16 C.F.R. pt. 310.4(a)(5)).

97. *Id.* at 42009.

98. *Id.* at 42007 n.225.

the risk associated with providing service for which they may never be compensated.[99]

When regulators interfere with the market by artificially cutting off the revenue stream that consumers are willing to support or by imposing artificial fee caps, they are not protecting consumers. Instead, they are threatening the availability of debt settlement by assuming that consumers cannot decide for themselves whether they will benefit from paying a fair price for debt-settlement services, and paternalistically substituting their own judgment for that of the American public. However, by preventing the market from determining what consumers are willing to pay for these services, these regulations and fee caps will force debt-settlement companies to pull out of restrictive states or shut down altogether.

What is even more troubling is that there appears to be no basis for setting the fee caps that already exist. In many states, legislators have delegated the power to set fee caps to state commissioners who do not support or publish their reasoning for setting unrealistically low caps.[100] Instead, these arbitrary market constraints seem to be based on the belief that debt-settlement services should be provided for free.[101] Perhaps this is a result of the relentless campaign by nonprofit credit counselors, who tout their nonprofit status and criticize debt-settlement companies for making a profit (although the counselors receive almost the same amount of revenue between fees and payments from the credit card companies).

The problem with the idea that debt-settlement services should be offered at no cost is that tax-exempt nonprofits

99. U.S. Organizations for Bankruptcy Alternatives, FTC Public Comment on Notice of Proposed Rulemaking 20 (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001).

100. In a very recent opinion, a Pennsylvania court struck down portions of the Pennsylvania debt-settlement statute because it unconstitutionally delegated too much authority to the state commissioner to set the limitations on how much debt-settlement companies could charge customers for their services. U.S. Orgs. for Bankr. Alternatives v. Dep't of Banking, No. 69 M.D.2009, 2010 WL 653756 (Pa. Commw. Ct. Feb. 25, 2010).

101. In his statements at the September 2008 FTC debt-settlement workshop, FTC Commissioner Rosch endorsed the statement that "debt settlement, *even at a cost*, can play an important role in solving what may seem like insurmountable problems of indebtedness," thus implying that debt settlement should ideally be offered at no cost. *Transcript of FTC Debt Settlement Workshop* 14 (Sept. 25, 2008) (statement of J. Thomas Rosch, Commissioner, FTC) (emphasis added).

cannot offer debt-settlement services.[102] In other words, there is no way to realistically offer "free" debt settlement within the current regulatory scheme. Thus, the only way to make sure that consumers have a meaningful less-than-full-balance repayment option at the fairest price is to allow a robust debt-settlement market to function through fair and transparent competition.[103] Therefore, state and federal regulators should focus on thwarting deceptive and misleading advertising and improving market transparency, rather than proceeding on assumptions that the entire industry should cease to exist or that fee caps selected by those outside of the marketplace can be efficiently set. A robust free market with healthy competition will naturally drive the price of debt-settlement services down to the lowest possible point at which debt-settlement companies can make a reasonable profit. If, on the other hand, governmental regulators pick artificial fee caps and strangle the free market, debt-settlement companies will simply be forced out of business and consumers will be left without an important debt-relief choice.

VIII. CONCLUSION

Lawmakers and regulators must recognize the importance of debt-settlement companies to struggling Americans who cannot find adequate help from nonprofit credit counselors or the bankruptcy courts. Rather than prohibiting these companies from contracting for tender of payment concurrent with their performance of services or arbitrarily capping the fees that debt-settlement companies can charge, these government actors should regulate other aspects of the industry. Specifically, they should focus their attention on preventing misrepresentation and deceptive advertising, while allowing the market to set the fair price and method of payment for debt-settlement services. If regulators instead proceed in enacting regulations as extreme

102. Robert E. Davis, FTC Public Comment on Notice of Proposed Rulemaking 5 (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001).

103. Regulation has won out over free markets, not because it makes more economic sense, but because it suits the political needs of those in power. Unfortunately, unchecked regulation and the court decisions that support it fail to recognize "the economic nature of contracts, competition, and market forces," because if they had "they would have been much less willing to substitute their own views of fairness for the agreements before them." Henry G. Manne, *The Judiciary and Free Markets*, 21 HARV. J.L. & PUB. POL'Y 11, 34 (1997).

as those discussed above, all debt-settlement companies—the beneficial ones along with the opportunistic—will be driven out of business, and the American consumer will be denied a potentially vital way out of credit card debt.